

GLOBAL MONITORING REPORT



2005



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*Millennium Development Goals:
From Consensus to Momentum*



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Contents

<i>Foreword</i>	xi
<i>Acknowledgments</i>	xiii
<i>Abbreviations and Acronyms</i>	xv
<i>Executive Summary</i>	xvii
<i>Millennium Development Goals (MDGs)</i>	xxii
1 Overview: Building Momentum toward the Millennium Development Goals	1
2 Spurring and Sustaining Economic Growth	17
3 Scaling Up Service Delivery	67
4 Realizing the Development Promise of Trade	117
5 Increasing Aid and Its Effectiveness	151
6 Strengthening and Sharpening Support from International Financial Institutions	189
<i>References</i>	239

Boxes

Millennium Development Goals	xxii
1.1 A five-point agenda for accelerating progress toward the MDGs	3
2.1 Growth is central to sustained poverty reduction	18
2.2 South Asia shows that stronger growth and better service delivery are key to the MDGs	24
2.3 Do poverty traps account for Africa's underdevelopment?	28
2.4 A gush of oil rents and surge in public investment do not ensure sustained growth	30
2.5 Political commitment is central to breaking the conflict cycle.	31

2.6	Better macroeconomic policies and stronger institutions are associated with longer growth accelerations	34
2.7	Challenges for fiscal policy in oil-producing Sub-Saharan countries	37
2.8	Fiscal transparency has improved in Africa, but much remains to be done.	39
2.9	Strengthening expenditure monitoring under the enhanced HIPC Initiative	42
2.10	Comparing business regulations in two resource-dependent economies: Angola and Botswana.	48
2.11	High returns to investment climate improvements in Uganda.	50
2.12	How does governance affect per capita incomes in Africa, and vice versa?	57
2.13	The Economic Commission for Africa's governance indicators and agenda	59
3.1	Sub-Saharan Africa shows that fast progress is possible in closing the gender gap	70
3.2	Reducing child mortality in Mozambique.	73
3.3	Improving sanitation in India's slums	77
3.4	Attracting doctors to rural areas in Thailand	88
3.5	IMF programs and MDG progress.	98
3.6	Scaling up service delivery in low-income countries under stress (LICUS).	101
3.7	Rewarding schools for MDG outcomes	108
4.1	The varying effects of the Agreement on Textiles and Clothing	124
4.2	Why has rapid export growth failed to significantly reduce poverty in Madagascar?	139
4.3	Many of the rents created by trade preferences accrue to importers	141
5.1	The U.S. Millennium Challenge Account—poised to deliver	155
5.2	Estimates of MDG financing needs vary widely, but all point to the need for a major increase	162
5.3	Addressing absorptive capacity in Ethiopia	164
5.4	Scaling up development efforts.	168
5.5	Alignment and harmonization: country examples show a wide variety of approaches	175
5.6	Mozambique's performance assessment framework—for donors	176
5.7	Proposals for additional debt relief—moving beyond HIPC	184
6.1	Profile of the "Big 5" multilateral development banks	191
6.2	Independent evaluation of the World Bank's role in poverty reduction strategies	194
6.3	Grant financing in the African and Asian Development Funds and IDA	200
6.4	IDA's strategy in Sub-Saharan Africa	209
6.5	Cambodia's country strategies—coordinating efforts among multiple donors	213
6.6	Malawi's sectorwide—and multisectoral—approach to HIV/AIDS	214
6.7	Multilateral development banks' support to build Colombia's culture of evaluation	218
6.8	IDA13's Results Measurement System—comparing targets and results	222

6.9	Indicators introduced under IDA14's Results Measurement System	223
6.10	IMF activities in Sub-Saharan Africa	226
6.11	Recent evaluations by the IMF's Independent Evaluation Office	228
6.12	Key elements of the IMF's role in low-income countries	230

Figures

1.1	Country focus and leadership are key to coherent and effective implementation of the MDG agenda	4
2.1	Growth prospects are promising, but wide regional disparities remain. . . .	21
2.2	Most regions will reach the poverty MDG by 2015, but Sub-Saharan Africa is seriously off track	23
2.3	Sub-Saharan Africa has lagged behind other regions	25
2.4	And the gap in income levels is widening	25
2.5	Lower investment rates in Sub-Saharan Africa have been a source of low growth	26
2.6	Sub-Saharan Africa has suffered from many conflicts.	31
2.7	Annual growth rates during accelerations are improving in Sub-Saharan Africa.	33
2.8	There is scope for allocating more to priority sectors such as health.	38
2.9	Sub-Saharan firms view taxes, finance, electricity, and corruption as particularly constraining	43
2.10	Sub-Saharan Africa lags other regions in the quality of the business environment	45
2.11	The cost of starting a business varies widely.	46
2.12	A weak investment climate entails high costs	50
2.13	Business environment reforms need to be scaled up in Sub-Saharan Africa.	51
2.14	Registering property is unduly time-consuming in Malawi.	51
2.15	Financial depth is lowest among low-income Sub-Saharan countries	52
2.16	The cost of borrowing is higher in Sub-Saharan Africa.	53
2.17	Weak access to infrastructure is a major constraint in Sub-Saharan Africa and South Asia	54
2.18	Infrastructure spending fails to meet needs, particularly in Sub-Saharan Africa.	55
2.19	Private participation in infrastructure remains low in most Sub-Saharan countries, and has recently fallen	55
2.20	Participatory processes are improving in developing countries, but most rapidly in Africa	58
	Stronger performance on political representation; weaker performance on public sector management and institutional effectiveness	60
3.1	Despite progress, the 2005 gender target will not be met	68
3.2	Several regions are off track to achieve to universal primary completion by 2015	71
3.3	Despite progress on child mortality, all regions are off track	72

3.4	Since 1990 the number of people living with HIV/AIDS has quadrupled.	74
3.5	Progress is being made in water supply, especially in South Asia . . . but sanitation progress is slower.	76
3.6	Progress on health does not always benefit poor people	78
3.7	Progress on education is generally more equitable	78
3.8	Health service coverage increases with the number of providers.	79
3.9	Provider presence is also associated with better health outcomes	80
3.10	Projected primary teacher needs are large in Sub-Saharan Africa	81
3.11	Projected primary teacher needs far exceed training capacity in many African countries	82
3.12	Low-income countries are spending more on health and education	89
3.13	Budget shares for health and education have increased in many regions. . .	90
3.14	Seventy percent of bilateral education aid is reported to be technical assistance	93
3.15	Donor commitments can oscillate substantially	94
3.16	Total ODA for health and education is increasing	96
3.17	Higher spending on education and health do not always mean better outcomes.	101
3.18	Leakage of funds can be high but is not inevitable	105
3.19	Absence rates can be very high, especially in health	107
4.1	LDC Exports: Less food and raw materials, more energy and apparel	120
4.2	Nontariff measures are more important in rich countries	126
4.3	Trade restrictiveness at home and abroad falls as countries become richer.	126
4.4	Trade restrictiveness at home and abroad rises with poverty headcount . . .	127
4.5	Agricultural protection is high in OECD countries, and border barriers account for most of it	128
4.6	OECD trade restrictiveness remains high for developing countries.	130
4.7	A low ambition round vs. deep WTO reforms	135
4.8	WTO Market access commitments for services by mode of supply.	136
4.9	Foreign direct investment and cross-border exchange account for most trade in services	137
4.10	Distribution of ODA for trade-related activities and infrastructure by region and main category	143
4.11	Bank trade-related lending	144
5.1	ODA is rising but is well short of what is needed; donors need to raise their post-Monterrey commitments and extend them beyond 2006	154
5.2	Wide variation in donor effort	155
5.3	Debt relief and technical assistance dominate the increase in ODA	156
5.4	Dependence on aid varies by region and is highest in Sub-Saharan Africa.	158
5.5	Sub-Saharan Africa's largest donors	158

5.6	Official flows are the main source of external finance for Sub-Saharan Africa, twice as large as FDI and nearly four times as large as remittances.	159
	Projected income poverty in Ethiopia, 2003–15 (Headcount index)	164
5.7	Higher development assistance is increasingly supporting and catalyzing more spending in priority areas	167
5.8	In low-income countries donors allocate more aid to better performers; more generous donors also tend to be more selective.	170
5.9	Difficult partnership countries receive less aid than predicted by their policy/institutional quality and poverty levels	171
5.10	Aid fragmentation is high, especially in Sub-Saharan Africa.	172
5.11	Progress on alignment, harmonization, and predictability of aid needs to be accelerated	177
6.1	Financial flows from the Big 5 multilateral development banks, IMF, and private sources	190
	Differences in the Big 5 client bases	191
	Average incomes of Big 5 client countries.	191
	Small states in the Big 5	192
	Borrower shares in Big 5 ownership.	192
	Big 5 decentralization.	192
6.2	Trends in lending and grant commitments by multilateral development banks.	197
6.3	Policy and poverty selectivity of aid from multilateral development banks, 2003.	201
6.4	Big 5 multilateral development banks: sectoral distribution of lending, 1999–2004	206
6.5	DFID Scorecard for multilateral development banks	221

Tables

2.1	Over the next 10 years growth is expected to rise and poverty fall around the world	22
2.2	Many Sub-Saharan countries require rapid growth to achieve the income poverty MDG	23
2.3	Macroeconomic policies are weaker in Sub-Saharan Africa than in other low-income countries	27
2.4	Growth accelerations have been much less common in Sub-Saharan Africa.	32
2.5	Macroeconomic indicators have generally improved in low-income countries	36
	Many HIPC countries need to substantially upgrade public expenditure management	42
2.6	Investment climate constraints vary across Sub-Saharan Africa	44
	Businesses face a lower regulatory burden in Botswana than Angola	48

3.1	Public health spending per capita has fallen in some regions	91
3.2	Significant additional financing is needed to achieve the health and primary education MDGs	92
4.1	Trade has grown rapidly in recent years, especially in developing countries.	119
4.2	Developing countries account for a growing share of non-oil exports . . .	119
4.3	Applied most favored nation tariffs are highest in South Asia and Sub-Saharan Africa	122
4.4	Nontariff measures remain high in several regions, 2002	122
4.5	Developing countries initiate more antidumping investigations, 1995–2003	123
4.6	A few large developing countries have launched the most antidumping investigations, 1995–2003	123
4.7	OECD trade restrictiveness is highest toward low-income countries, 2002.	129
4.8	Globally, trade restrictiveness is highest for agriculture, 2002	129
4.9	Developing countries impose high restrictions on trade with one another, 2002.	131
4.10	Key elements of the August 2004 WTO framework agreement	132
4.11	Most economic welfare benefits of full merchandise trade liberalization would come from agriculture, 2015	133
4.12	Developing countries have made fewer market access and national treatment commitments for services under the WTO	137
	Estimates of additional ODA requirements vary widely	162
5.1	Selectivity in aid allocation: Donors' policy and poverty focus is improving, but bilateral donors could do more	169
5.2	Indicators of progress (on ownership, harmonization, alignment, and results).	174
5.3	African governments are viewing donor behavior more favorably	179
5.4	Debt service is falling and poverty-reducing spending rising among the 27 HIPC countries that have reached their decision points	182
6.1	Country strategies of multilateral development banks	196
6.2	Lending instruments of multilateral development banks	199
6.3	Transparency among multilateral development banks	217
6.4	Managing for development results in multilateral development banks . . .	218
6.5	Project monitoring, evaluation, and reporting in multilateral development banks	220

Foreword

The *Global Monitoring Report 2005* is the second in a series of annual reports assessing progress on the policy agenda for achieving the Millennium Development Goals (MDGs) and related outcomes. It is prepared jointly by the staff of the World Bank and the International Monetary Fund (IMF), in close collaboration with partner agencies. This report comes at an important time, when the international development community is taking stock of implementation of the Millennium Declaration in the five years since its adoption and discussing how progress toward the MDGs can be accelerated. We hope that the analysis presented in this report will make a useful contribution to those efforts.

The report's central message is clear: without early and tangible action to accelerate progress, the MDGs will be seriously jeopardized—especially in Sub-Saharan Africa, which at current trends will fall short of all the goals. At stake are prospects not only for hundreds of millions of people to escape poverty, disease, and illiteracy, but also for long-term peace and security—objectives intimately linked to development. During 2005 the international community must seize the opportunities presented by increased global attention on development to build momentum for the MDGs. Special focus must be

given to accelerating progress in Sub-Saharan Africa.

How to generate momentum? This report sets out an agenda spanning the responsibilities of all key actors. Developing countries must take the lead in articulating and implementing development strategies that aim higher. They should build on recent progress on reforms by deepening improvements in policies and governance to achieve stronger economic growth and scale up human development and related key services. The recent pickup in growth in many developing countries, including several Sub-Saharan countries, demonstrates the payoff to reforms.

Developed countries must step up implementation of the commitments they made as part of the Monterrey Consensus. They should substantially increase the volume of development aid and improve its delivery to facilitate more effective use by recipients. And they should show leadership on trade policy reforms that open markets to developing country exports and that give greater coherence to developed country policies in terms of their impact on development. Progress on both aid and trade is crucial—and the need for action urgent.

International financial institutions should strengthen and sharpen their support for this agenda. A priority for us is to strengthen our

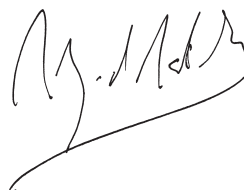
support for country-led poverty reduction strategies in low-income countries and sharpen our focus on development results. We also need to continue to adapt our approaches and instruments to the evolving and varying needs of middle-income countries. Geared to the needs of both low- and middle-income countries, international financial institutions should also do more



James D. Wolfensohn
President
World Bank

and better on global and regional public goods.

With just 10 years until 2015, achieving the MDGs seems daunting, especially in Sub-Saharan Africa. But rapid progress is possible if there is sufficient commitment to reform and support from development partners, within the framework of the enhanced global partnerships envisaged at Monterrey.



Rodrigo de Rato
Managing Director
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Abbreviations and Acronyms

ACP	African, Caribbean, and Pacific	EPA	Economic Partnership
ACT	Artemisinin combination		Agreement
	treatment	EU	European Union
AfDB	African Development Bank	FDI	Foreign direct investment
AGOA	African Growth and	FSAP	Financial Sector Assessment
	Opportunity Acceleration Act		Program (IMF)
AIDS	Acquired immune deficiency	FSO	Fund for Special Operations
	syndrome		(Inter-American Development
APRM	African Peer Review		Bank)
	Mechanism	FTI	Fast Track Initiative (Education
ADB	Asian Development Bank		For All)
ASEAN	Association of South-East	GAO	U.S. General Accounting Office
	Asian Nations	GATS	General Agreement on Trade in
BEEP	Business Environment and		Services
	Enterprise Performance Survey	GAVI	Global Alliance for Vaccination
CAS	Country assistance strategy		and Immunization
CPIA	Country policy and	GFATM	Global Fund to Fight AIDS,
	institutional assessment		Tuberculosis, and Malaria
DAC	Development Assistance	GNI	Gross national income
	Committee (OECD)	HIPC	Heavily indebted poor country
DANIDA	Danish International	HIV	Human immunodeficiency
	Development Agency		virus
DFID	U.K. Department for	IBRD	International Bank for
	International Development		Reconstruction and
DIME	Development Impact		Development (World Bank)
	Evaluation (World Bank)	ICRG	International Country Risk
DOTS	Directly observed treatment		Guide
	strategy	IDA	International Development
EBRD	European Bank for		Association (World Bank)
	Reconstruction and	IDB	Inter-American Development
	Development		Bank
ECLAC	United Nations Economic	IEO	Independent Evaluation Office
	Commission for Latin America		(IMF)
EFA	Education For All	IFC	International Finance
EFF	Extended Fund Facility (IMF)		Corporation (World Bank)

IFF	International Finance Facility	PEFA	Public Expenditure and Financial Accountability program
IFFIm	International Finance Facility for Immunization		
IFI	International financial institution	PEPFAR	U.S. President's Emergency Plan for AIDS Relief
IMF	International Monetary Fund	PETS	Public Expenditure Tracking Survey (World Bank)
LDC	Least developed country	PRGF	Poverty Reduction and Growth Facility (IMF)
LICUS	Low-income countries under stress	PRS	Poverty Reduction Strategy
MAP	Multi-country AIDS Program (World Bank)	PRSC	Poverty Reduction Support Credit (World Bank)
MCA	Millennium Challenge Account	PRSP	Poverty Reduction Strategy Paper
MDB	Multilateral development bank	PSIA	Poverty and Social Impact Analysis (IMF)
MDG	Millennium Development Goal	QAG	Quality Assurance Group (World Bank)
MFN	Most favored nation	ROSC	Report on the Observance of Standards and Codes
MIF	Multilateral Investment Fund (Inter-American Development Bank)	SDR	Special Drawing Right (IMF)
MIGA	Multilateral Investment Guarantee Agency (World Bank)	SPA	Strategic Partnership for Africa
MTEF	Medium-term expenditure framework	SWAp	Sectorwide approach
NAFTA	North American Free Trade Agreement	TRAINS	Trade Analysis and Information System (UNCTAD)
NEPAD	New Partnership for Africa's Development	UN	United Nations
NGO	Nongovernmental organization	UNAIDS	Joint United Nations Programme on HIV/AIDS
NLF	New Lending Framework (Inter-American Development Bank)	UNCTAD	United Nations Conference on Trade and Development
ODA	Official development assistance	UNDP	United Nations Development Programme
OECD	Organisation for Economic Co-operation and Development	UNECA	United Nations Economic Commission for Africa
OED	Operations Evaluation Department (World Bank)	UNESCO	United Nations Educational, Scientific, and Cultural Organization
OLS	Ordinary least squares	UNICEF	United Nations Children's Fund
OTRI	Overall trade restrictiveness index	VAT	Value added tax
OVE	Office of Evaluation and Oversight (Inter-American Development Bank)	WHO	World Health Organization
PAHO	Pan-American Health Organization	WP-EFF	Working Party on Aid Effectiveness and Donor Practices
PARIS21	Partnership in Statistics for Development in the 21st Century	WTO	World Trade Organization

Executive Summary

Bold actions are urgently needed if the development vision that world leaders laid out in remarkable unison at the turn of the century is to be realized. The Millennium Development Goals (MDGs) and the Monterrey Consensus have created a powerful global compact for development. The MDGs set clear targets for eradicating poverty and related human deprivations. The Monterrey Consensus stresses the mutual accountability of developing and developed countries in achieving these goals. But the continued credibility of this compact hinges on expediting its implementation. Nearly five years have passed since the Millennium Declaration was adopted, and current stocktaking of progress during that time has focused global attention on the need to scale up action—making 2005 a crucial year to build momentum for the MDGs.

Without faster progress, the MDGs will be seriously jeopardized—especially in Sub-Saharan Africa, which is off track on all the goals. At stake are prospects not only for hundreds of millions of people to escape poverty, disease, and illiteracy, but also prospects for long-term global security and peace—objectives intimately linked to development. Behind cold statistics on the MDGs are real people, and lack of progress has immediate and tragic consequences. Every week in the developing world, 200,000 chil-

dren under five die of disease and 10,000 women die giving birth. In Sub-Saharan Africa alone, 2 million people will die of AIDS this year. And as many as 115 million children in developing countries are not in school. The need to scale up and speed up action is thus urgent, and the opportunities presented by the year 2005 must be seized.

To be sure, there has been progress. Developing countries have continued to improve their policies and governance, which has contributed to an encouraging acceleration in their economic growth. Even Sub-Saharan Africa may be turning the corner, with several countries in the region showing notable progress in reforming policies and reviving growth. Developed countries have increased aid and introduced actions to make it more effective. Some initial steps have also been taken toward trade policy reform. But, overall, progress has been slower than envisaged, uneven across policy areas and countries, and far short of what is needed to achieve the MDGs.

With just a decade to go until 2015, achieving the MDGs seems daunting, especially in Sub-Saharan Africa. But rapid progress is possible—if there is sufficient commitment to reform and sufficient support from development partners. Better-performing developing countries provide reasons for hope for others. Even in many lagging countries, including in Sub-Saharan Africa, advances are being made

and the ground is being laid for better performance. What is needed is to quicken and broaden this progress, based on the framework of the enhanced global partnership envisaged at Monterrey.

How to generate momentum and broaden progress? Developing countries must take the lead in articulating and implementing strategies that aim higher—to rise above current trends and substantially accelerate progress. Deeper improvements are needed in policies and governance, to expedite economic growth and scale up human development and related key services. Developed countries must also step up implementation of their part of the development compact. They must provide more and better aid but also show leadership on trade policy reform that would open markets for developing country exports and give greater coherence to their policies in terms of their impact on development.

A Five-Point Agenda

To build the momentum needed to achieve the MDGs, this report proposes a five-point agenda of accelerated and concerted actions by developing and developed countries—based on the Monterrey framework of mutual accountability. Within this agenda, special focus must be given to accelerating progress in Sub-Saharan Africa, the region that is furthest from the development goals but that has recently demonstrated a capacity for improvement in economic performance—capacity that must be fostered through further domestic reform and stronger support from development partners.

Anchor Actions to Achieve the MDGs in Country-Led Development Strategies

- For coherence and effectiveness, the scaling up of development efforts at the country level must be guided by country-owned and -led poverty reduction strategies (PRSs) or equivalent national development strategies. Framed against a long-term development vision, these strategies should

set medium-term targets—tailored to country circumstances—for progress toward the MDGs and related development outcomes. And they should define clear national plans and priorities for achieving those targets, linking policy agendas to medium-term fiscal frameworks. Donors should use these strategies as the basis for aligning and harmonizing assistance.

Improve the Environment for Stronger, Private Sector–Led Economic Growth

- Promotion of economic growth must be at the center of the strategy to achieve the MDGs. Sub-Saharan Africa needs to almost double its growth rate, to an annual average of about 7 percent over the next decade.
- Progress in macroeconomic management should be deepened, with a focus on fiscal management and the structure of public spending—to create more fiscal space for priority expenditures while ensuring fiscal sustainability.
- Improving the enabling climate for private activity—by removing regulatory and institutional constraints and strengthening infrastructure—is key. An important area of reform in many countries is the strengthening of property rights and the rule of law, including legal and judicial reform. Countries should use the improved diagnostics and metrics of the private business environment now available (such as the World Bank’s Doing Business Indicators and Investment Climate Surveys) to guide action and monitor progress. Spending on infrastructure, for both investment and operation and maintenance, needs to rise in all regions but must double in Sub-Saharan Africa—from about 4.7 percent of GDP in recent years to more than 9 percent over the next decade—as gaps in infrastructure are especially severe in that region. Across countries, the pace of the increase in investment will depend on institutional capacity and macroeconomic conditions.

- Overarching this agenda is the need to improve governance—upgrading public sector management, controlling corruption—as doing so is crucial to both the private sector’s business environment and the public sector’s development interventions. The New Partnership for Africa’s Development and its African Peer Review Mechanism are promising African-led initiatives with a focus on strengthening institutions. Member countries should take advantage of the impetus they provide to develop and implement national capacity building strategies, which donors should support. Developed countries can also help curb corruption by demanding high standards from their companies active in developing countries, including by giving high-level political endorsement to the Extractive Industries Transparency Initiative.

Scale Up Human Development Services

- The human development MDGs require a major scaling up of education and health services—primary education, basic health care and control of major diseases such as HIV/AIDS, and women’s access to education and health care—and of water and sanitation infrastructure, which is closely linked to health outcomes. Again, the shortfalls are most serious, and the need to scale up most urgent, in Sub-Saharan Africa.
- Critical to effective scaling up are: rapidly increasing the supply of skilled service providers (health workers, teachers); providing increased, flexible, and predictable financing for these recurrent cost-intensive services; and managing the service delivery chain to ensure that money produces results.
- To strengthen the Education for All Fast Track Initiative, partners should make monitorable, public, long-term commitments to significant annual increases in funding for primary education. Still larger additional resources are needed to achieve the health MDGs. It is important to ensure that global programs organized around spe-

cific health interventions are aligned with recipient countries’ priorities and support—rather than undermine—the coherence of their health sector strategies and systems.

Dismantle Barriers to Trade

- The international community must aim for an ambitious outcome to the Doha Round that fully realizes its development promise, including in particular a major reform of agricultural trade policies in developed countries. The round should be completed by 2006.
- “Aid for trade” should be scaled up substantially to help poor countries address behind-the-border constraints to their trade capacity, including through investments in critical trade-related infrastructure.

Substantially Increase the Level and Effectiveness of Aid

- Official development assistance (ODA) must at least double in the next five years to support the MDGs, particularly in low-income countries and Sub-Saharan Africa, with the pace of the increase aligned with recipients’ absorptive capacity. To signal that needed resources will be forthcoming, 2005 is an opportune time for donors to raise their initial post-Monterrey commitments and extend them over a longer time horizon—2010 or beyond. Also, exploration should continue on the merits and feasibility of innovative financing mechanisms to complement increased aid flows and commitments.
- Equally important is improving the quality of aid, with faster progress on alignment and harmonization, and delivery modalities that increase aid flexibility and predictability. Firm implementation of the Paris Declaration on Aid Effectiveness is central to this agenda.
- Closure should be reached in 2005 on current proposals for additional debt relief for poor countries with heavy debt burdens

that are pursuing credible reforms. Any additional debt relief should not cut into the provision of needed new financing—which for these countries should be primarily in the form of grants—and should not undermine the financial viability of international financial institutions.

Role of International Financial Institutions

How should international financial institutions—multilateral development banks and the International Monetary Fund (IMF)—strengthen and sharpen their support for this agenda? This report emphasizes action in five areas, as outlined below. In each of these areas there has been progress, but there is a need to do more and pick up the pace. The priorities for action and monitoring progress are:

- Support the deepening of the PRS framework in low-income countries, and the operationalization of the MDGs and alignment of assistance within that framework. For low-income countries under stress, support to building institutional capacities is especially important.
- Continue to adapt approaches and instruments to better respond to the evolving and differentiated needs of middle-income countries, including further streamlining of conditionality and investment lending.
- Ensure that the implications of dismantling trade barriers and increasing the scale and effectiveness of aid are adequately reflected in support for country capacity building, so that emerging opportunities can be fully utilized. International financial institutions should sharpen the strategic focus and improve the effectiveness of their support for global and regional public goods.
- Strengthen partnerships and harmonize further by improving transparency, reducing red tape and enhancing the flexibility of assistance (through simplification and use of sectorwide approaches), and promoting the development and use of country systems—for procurement, financial management, and environmental assessment.
- Strengthen the focus on results and accountability by supporting country efforts to manage for development results—strengthening public sector management and development statistics—and furthering progress within international financial institutions in enhancing the results orientation of their country strategies and quality assurance processes. Adopt a common framework for self-evaluation of multilateral development banks' performance and results measurement, and adapt to IMF operations as much as possible.

Millennium Development Goals (MDGs)

Goals and Targets from the Millennium Declaration

GOAL 1	ERADICATE EXTREME POVERTY AND HUNGER
TARGET 1	Halve, between 1990 and 2015, the proportion of people whose income is less than \$1 a day
TARGET 2	Halve, between 1990 and 2015, the proportion of people who suffer from hunger
GOAL 2	ACHIEVE UNIVERSAL PRIMARY EDUCATION
TARGET 3	Ensure that by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling
GOAL 3	PROMOTE GENDER EQUALITY AND EMPOWER WOMEN
TARGET 4	Eliminate gender disparity in primary and secondary education, preferably by 2005, and at all levels of education no later than 2015
GOAL 4	REDUCE CHILD MORTALITY
TARGET 5	Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate
GOAL 5	IMPROVE MATERNAL HEALTH
TARGET 6	Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio
GOAL 6	COMBAT HIV/AIDS, MALARIA, AND OTHER DISEASES
TARGET 7	Have halted by 2015 and begun to reverse the spread of HIV/AIDS
TARGET 8	Have halted by 2015 and begun to reverse the incidence of malaria and other major diseases
GOAL 7	ENSURE ENVIRONMENTAL SUSTAINABILITY
TARGET 9	Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources
TARGET 10	Halve by 2015 the proportion of people without sustainable access to safe drinking water and basic sanitation
TARGET 11	Have achieved a significant improvement by 2020 in the lives of at least 100 million slum dwellers
GOAL 8	DEVELOP A GLOBAL PARTNERSHIP FOR DEVELOPMENT
TARGET 12	Develop further an open, rule-based, predictable, nondiscriminatory trading and financial system (including a commitment to good governance, development, and poverty reduction, nationally and internationally)
TARGET 13	Address the special needs of the least developed countries (including tariff- and quota-free access for exports of the least developed countries; enhanced debt relief for heavily indebted poor countries and cancellation of official bilateral debt; and more generous official development assistance for countries committed to reducing poverty)
TARGET 14	Address the special needs of landlocked countries and small island developing states (through the Programme of Action for the Sustainable Development of Small Island Developing States and the outcome of the 22nd special session of the General Assembly)
TARGET 15	Deal comprehensively with the debt problems of developing countries through national and international measures to make debt sustainable in the long term
TARGET 16	In cooperation with developing countries, develop and implement strategies for decent and productive work for youth
TARGET 17	In cooperation with pharmaceutical companies, provide access to affordable, essential drugs in developing countries
TARGET 18	In cooperation with the private sector, make available the benefits of new technologies, especially information and communication

Note: The Millennium Development Goals and targets come from the Millennium Declaration signed by 189 countries, including 147 heads of state, in September 2000. The goals and targets are related and should be seen as a whole. They represent a partnership of countries determined, as the Declaration states, "to create an environment—at the national and global levels alike—which is conducive to development and the elimination of poverty."

Source: United Nations. 2000 (September 18). *Millennium Declaration*. A/RES/55/2. New York.

United Nations. 2001 (September 6). *Road Map towards the Implementation of the United Nations Millennium Declaration*. Report of the Secretary General. New York.

Overview: Building Momentum toward the Millennium Development Goals

The Millennium Development Goals (MDGs) and the Monterrey Consensus have created a powerful global compact for development.¹ But the continued credibility of this compact hinges on fostering momentum in its implementation. With the five-year stocktaking of implementation of the Millennium Declaration focusing increased global attention on development, 2005 is a crucial year to build momentum.

Without tangible action to accelerate progress, the MDGs will be seriously jeopardized. At stake are prospects not only for hundreds of millions of people to escape poverty, disease, and illiteracy, but also for long-term global security and peace—objectives that are intimately linked to development. Behind cold data on the MDGs are real people, and lack of progress on the goals has immediate and tragic consequences. Every week in the developing world, 200,000 children under five die of disease and 10,000 women die giving birth. In Sub-Saharan Africa alone, 2 million people will die of AIDS this year. Moreover, 115 million children in developing countries are not in school. The need to scale up and speed up action is thus urgent, and the opportunities presented by the year 2005 must be seized.

The MDGs set clear targets for dramatically reducing poverty and related human

deprivations and for promoting sustainable development. The Monterrey Consensus created a framework of mutual accountability between developing and developed countries in the quest for these goals, calling on developing countries to improve their policies and governance and developed countries to open their markets and provide more and better aid. With consensus reached on the MDGs and on responsibilities for action, the focus of development efforts shifted to implementation. As this report shows, both groups of countries have made progress on needed policies and actions. But progress has been uneven and slower than envisaged. The pace must pick up if the vision of the Millennium Declaration is to be realized—hence the title of this report.

This report should be read in the context of the broader review of progress on the development agenda in 2005, which includes several other major reports—the UN Secretary-General's report, the UN Millennium Project report, and the Commission for Africa report.² All these reports complement one another in assessing, from their respective vantage points, progress toward the MDGs and related goals and in identifying priorities for the agenda ahead. They all share the common objective of expediting and broadening progress toward these goals.

Daunting Challenges— and Grounds for Hope

Globally, prospects are promising for halving income poverty between 1990 and 2015—the first MDG. China and India, the two countries with the highest numbers of poor people, have achieved strong, sustained growth and made major, rapid progress in reducing poverty. Due largely to their efforts, East Asia has already achieved the poverty MDG, and South Asia is on target. Most other developing regions are also making steady progress and are expected to achieve the goal or come close—though some countries will fall short in every region, and others will continue to have large pockets of poverty even while meeting the goal at the national level. In Sub-Saharan Africa the momentum has been much slower, and most countries are at risk of falling far short. Indeed, between 1990 and 2001 the incidence of poverty rose in Sub-Saharan Africa. Almost half of the region's population lives on less than \$1 a day.

Across regions, the risks of falling short are far greater for the human development MDGs. Prospects are gravest in health. On current trends, most regions will fall short—some seriously—of the health and related goals, including reduced child and maternal mortality and increased access to sanitation. The number of people with HIV/AIDS continues to grow. Prospects are brighter in education, but in three of the six developing regions the pace of progress is too slow to attain the goal of universal primary school completion. Although significant progress has been made in all regions in reducing gender disparities in education, again half of the regions will not achieve the goal of gender equality in primary and secondary education by 2005. Prospects for achieving gender equality in tertiary education by 2015 are even less encouraging. Sub-Saharan Africa is off track on all these goals.

Against this backdrop, and with just 10 years until 2015, achieving several of the MDGs seems daunting. Indeed, it is a huge challenge. But rapid progress is possible. The

success of better-performing regions and countries provides reason for hope for others. A particularly striking example is Vietnam, a low-income country that reduced poverty from 51 percent in 1990 to 14 percent in 2002. And even in many lagging countries, including in Sub-Saharan Africa, progress is being made and the ground is being laid for better performance. This progress needs to be furthered and quickened, within the framework of the enhanced partnership for global development envisaged at Monterrey.

Building Momentum: A Five-Point Agenda

How to generate momentum and broaden progress? Developing countries must take the lead in articulating and implementing strategies that aim higher, to rise above current trends and substantially accelerate progress. That will require improving policies and governance to achieve stronger economic growth and scaling up human development and key related services. Developed countries must also bolster their efforts and live up to the commitments they made at Monterrey. Providing more and better aid is an important part of such efforts. But a big push in aid is not the sole answer. International development policy needs to move beyond aid and aim for a set of actions that cohere into a broader big push—including, importantly, trade policy reform but also other policies that affect development, such as those involving private capital flows, knowledge and technology transfer, security, and the environment.

Based on its analysis, the report proposes a five-point agenda for accelerating progress toward the MDGs (box 1.1). Within its global coverage, the report has a special focus on Sub-Saharan Africa—the region that is furthest from the development goals and faces the toughest challenges in accelerating progress.³ But much of the analysis of Sub-Saharan countries is relevant for similar countries in other regions. For example, Sub-Saharan Africa contains the largest number of least developed countries (LDCs) and

BOX 1.1 A five-point agenda for accelerating progress toward the MDGs*Anchor efforts to achieve the MDGs in country-led development strategies*

- Operationalize the MDGs in country-owned and -led poverty reduction strategies, linked to medium-term fiscal frameworks. Donors should use these strategies as the basis for aligning and harmonizing assistance.

Improve the environment for stronger, private sector-led economic growth

- Strengthen fiscal management, with a focus on the structure of public spending.
- Improve the enabling climate for private activity by removing regulatory and institutional constraints and strengthening economic infrastructure.
- Improve governance by upgrading public sector management and combating corruption.

Scale up human development services

- Rapidly increase the supply of skilled service providers (health workers, teachers).
- Provide increased, flexible, and predictable financing for these recurrent cost-intensive services.
- Manage the service delivery chain to ensure that money produces results.

Dismantle barriers to trade

- Achieve an ambitious outcome to the Doha Round that fully realizes its development promise, including in particular a major reform of agricultural trade policies in high-income countries, completing the round no later than 2006.
- Augment assistance to poor countries to address behind-the-border constraints to their trade capacity, including through investments in critical trade-related infrastructure.

Substantially increase the level and effectiveness of aid

- Double official development assistance over the next five years to support the MDGs, particularly in low-income countries and Sub-Saharan Africa, aligning the pace of the increase with recipients' absorptive capacity.
- Improve the quality of aid, with faster progress on alignment and harmonization, and delivery modalities that increase aid flexibility and predictability.
- Reach closure in 2005 on current proposals for additional debt relief. Any additional debt relief should not cut into the provision of needed new financing—nor undermine the financial viability of international financial institutions.

low-income countries under stress (LICUS). But other regions also contain countries in these groups, with similar characteristics and challenges. For example, East Asia, though better known for its major emerging market economies, contains 6 of the 25 LICUS.

Anchoring Efforts in Country-Led Development Strategies

An overarching theme of this report is the centrality of country-based development strategies in pursuing the MDGs. Country-owned and -led poverty reduction strategies

(PRSS) should provide the framework for operationalizing the MDGs at the country level in low-income countries. (Equivalent national development strategies should perform this role in middle-income countries.) Framed against a long-term development vision, PRSSs should define medium-term targets, tailored to country circumstances, for progress toward the MDGs and related development outcomes. They should also articulate a clear national plan and priorities for achieving those targets, including policy reforms, institutional strengthening, and investments. The development program set

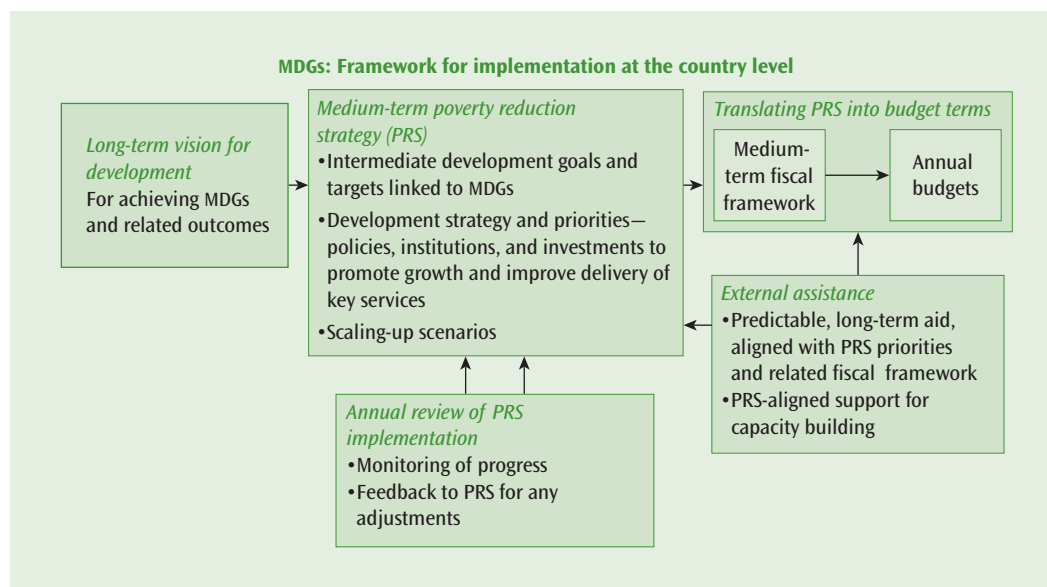
out in a PRS should be linked to a medium-term fiscal framework and annual budgets to align budget allocations with program priorities. Donors should use this framework of nationally articulated priorities—and their budget implications—to align and harmonize their assistance. In this way the PRS process can bring coherence both to the setting and implementation of national priorities for achieving the MDGs and to donor support for the country. It can also, through annual reviews of PRS implementation, provide a mechanism for monitoring progress on the development program in an integrated manner and for adjusting it as needed (figure 1.1).

To perform this central strategic and operational role effectively, PRSs need strengthening in many countries. Overall, there has been good progress in extending and deepening the PRS process in developing countries. At present, 47 countries are implementing PRSs, and another 12 have prepared interim PRSs. Of these, 33 are Sub-Saharan countries. Countries are increasingly reflecting the MDGs more centrally in their PRSs. The PRS process is also being deepened along various

dimensions, including its transparency and inclusiveness, articulation of the growth agenda, attention to institutional capacity building (such as public expenditure management), and incorporation of poverty and social impact analysis. But progress on these dimensions varies across countries.

Going forward, an area requiring particular attention is strengthening the links between PRSs and fiscal frameworks, which in most countries will require further development of medium-term expenditure frameworks. This is key both for enhancing the operational effectiveness of PRSs for national authorities in setting and implementing development priorities and for donors in better aligning their support with country priorities. In most low-income countries, achieving the MDGs will require a major scaling up of development efforts. Countries should use the PRS framework to assess alternative scenarios that can help them map out how to scale up, drawing implications for intensified domestic policy reform, mobilization of additional external assistance, and enhancement of absorptive capacity.

FIGURE 1.1 Country focus and leadership are key to coherent and effective implementation of the MDG agenda



Spurring and Sustaining Economic Growth

PRs and other national development strategies must define clear programs for promoting stronger and sustained economic growth, and governments must firmly commit to those programs. Growth is central to achieving the MDGs and related development outcomes. It reduces poverty directly and expands resources and capacities for achieving the nonincome MDGs. In recent years developing countries have achieved an encouraging pickup in economic growth, thanks to continuing progress on improving policies and governance. In 2004 GDP growth in developing countries averaged 6.7 percent—the highest level in three decades.

Sub-Saharan Africa also appears to be turning the corner. Twelve countries in the region—such as Ghana, Mali, Mozambique, Tanzania, and Uganda—are experiencing growth accelerations of the type more commonly associated with other regions, with annual GDP growth averaging more than 5.5 percent since the mid-1990s. Many African countries face region-specific handicaps, including unfavorable geography, vulnerability to shocks, and widespread disease. Still, as in other regions, policies and institutions matter in achieving higher growth. Differences in policies and institutions largely explain the differences in growth and poverty reduction between other regions and Sub-Saharan Africa and among countries in Sub-Saharan Africa. Sound policies also position countries better to deal with economic shocks.

The recent strengthening of growth is only the beginning of what Sub-Saharan Africa needs to achieve and sustain necessary improvements in income levels. Historically, it has been far more difficult for countries to sustain growth than to initiate it. To achieve the income poverty MDG, Sub-Saharan Africa would have to achieve average annual GDP growth of around 7 percent over the next decade—almost twice the current rate. Though this is a big challenge, past achievements by countries in other regions and some

Sub-Saharan countries show that rapid progress is possible if there is sufficient commitment to reform and support from development partners.

Specific priorities and sequencing of actions to promote growth necessarily vary by country. Across developing countries there is considerable diversity in economic circumstances. Sub-Saharan Africa alone contains middle-income countries and least developed countries, large countries and small island economies, resource-rich countries (including oil exporters) and resource-poor countries, coastal countries and landlocked countries, and countries experiencing conflict and other forms of severe stress. Thus the specifics of the policy agenda for growth at the country level must be defined as part of individual country development strategies. Looking across countries, this report's analysis finds that three broad areas require particular attention.

DEEPENING PROGRESS ON MACROECONOMIC MANAGEMENT

Macroeconomic management has improved in all regions, yet progress has been uneven and remains fragile in many countries. The main area requiring attention is fiscal management, particularly the structure and quality of public spending—to create more fiscal space for priority expenditures while ensuring fiscal sustainability. Better public expenditure management would allow allocations to growth-promoting and poverty-reducing spending to rise in a way consistent with sustainable fiscal and debt positions. The scope for such improvements in spending remains considerable in many countries. Sound fiscal management and macroeconomic stability are also important underpinnings of an environment conducive to growth in private investment.

IMPROVING THE ENABLING CLIMATE FOR PRIVATE SECTOR ACTIVITY

A vigorous private sector drives economic growth, but government plays a vital role in creating a climate where entrepreneurship can

flourish. An improved business environment not only delivers higher and more productive private investment, it also expands the private sector by establishing a level playing field—encouraging small businesses (often the most dynamic business segment), inducing a shift from the informal to the formal economy, and better engaging the energies of women. A better business environment is also essential to attracting more foreign investment. Action is needed on two fronts:

- *Improving the regulatory and institutional environment for private activity*, with a focus on simplifying regulations for starting a business, securing property rights, and strengthening contract enforcement and the rule of law. Access to finance also needs to be improved, but fundamentally depends on the same regulatory and institutional underpinnings. Sub-Saharan Africa considerably lags other regions on these dimensions. Countries should use the improved diagnostics and metrics of the private business environment now available—such as the World Bank’s Doing Business Indicators and Investment Climate Surveys—to guide action and monitor progress. Further reductions in trade barriers (discussed below) are also needed to improve the climate for private investment and growth.
- *Substantially increasing investment in physical infrastructure*, promoting private participation, and reversing the decline in public investment that persisted for much of the past decade—recognizing that the bulk of the increase in infrastructure investment, especially in Sub-Saharan Africa, will have to come from the public sector. Gaps in infrastructure are especially severe in Sub-Saharan Africa, reflecting low past investment as well as the large needs implied by the region’s challenging geography—such as for transportation linking distant rural areas to markets (key to boosting agriculture, which accounts for the bulk of employment in most countries) and regional infrastructure linking landlocked countries to interna-

tional trade. Infrastructure spending (investment plus operation and maintenance) will need to rise in all regions to support stronger growth and service delivery consistent with MDG targets. But such spending will need to double in Sub-Saharan Africa, from about 4.7 percent of GDP in recent years to 9.2 percent over the next decade—implying annual infrastructure spending of about \$20 billion and a need for about \$10 billion a year in additional external financing. The increase in spending will need to be managed well to ensure effectiveness and quality, with the pace of the increase depending on institutional capacity and macroeconomic conditions in the countries concerned.

STRENGTHENING PUBLIC SECTOR GOVERNANCE

Improving governance—upgrading public sector management, controlling corruption—overarches this agenda, because it is crucial to both the private sector’s business environment and the public sector’s development interventions. Although governance is getting better in most countries, reforms need to be accelerated in many. Sub-Saharan Africa has seen encouraging progress on political representation, reflecting a trend toward broader participatory processes that enable citizens to influence policymaking and hold leaders accountable. There has been less progress on public sector management and institutional effectiveness. But the improvements in political institutions could create the momentum needed to strengthen institutions of economic governance. The African Peer Review Mechanism, recently introduced by the African Union’s New Partnership for Africa’s Development (NEPAD), focuses on improving governance and could provide impetus. Informed by the peer reviews, countries should develop capacity building strategies, with NEPAD providing a forum to share best practices, reinforce peer pressure, and advocate for external support. External partners should support the strengthening of this promising African-led reform framework. Developed countries can also help curb corruption by demanding high standards

from their companies active in developing countries, including by giving high-level political endorsement to the Extractive Industries Transparency Initiative.

The context for economic growth in Sub-Saharan Africa also appears to be improving in terms of the region's peace and security outlook, with some decline in the incidence of conflicts. Still, preventing, managing, and recovering from conflicts remain major challenges in the region.

Long-term growth prospects also depend on ensuring environmental sustainability. An important element of the agenda is enhancing access to reliable, affordable, and clean energy options. So is checking environmental degradation to mitigate the threat of increased climatic volatility. Environmental sustainability is an MDG in its own right, but it has strong links to the achievement of many other goals.

Scaling Up Service Delivery

The human development MDGs require a major scaling up of education and health services—including primary education, basic health care and control of diseases such as HIV/AIDS, and women's access to education and health care—and of water and sanitation infrastructure, which is closely linked to health outcomes. The shortfalls are most serious, and the need to scale up most urgent, in Sub-Saharan Africa.

As with the growth agenda, priorities for action in scaling up human development services must be determined in the context of country-owned development strategies. The appropriateness of individual interventions, be they “quick wins” or longer-term efforts, needs to be evaluated in these country-specific frameworks. The analysis in this report finds that most countries face three critical challenges in scaling up service delivery.

INCREASING THE SUPPLY OF SKILLED SERVICE PROVIDERS

Expanding education and health services on the scale needed to achieve the MDGs will require major increases in the supply of teachers, doc-

tors, nurses, and community health workers—especially in Sub-Saharan Africa. Estimates suggest that the region will need to as much as triple its health workforce by 2015, adding 1 million workers. The impact of AIDS on the workforce is exacerbating the capacity problem in countries such as Malawi, Tanzania, and Zambia. Human resource shortages will likely be a binding constraint on service expansion, especially in health, unless countries adapt policies and increase provider productivity. Strategies that are proving effective include:

- Pragmatic adjustments to recruitment and training standards, to increase production of community teachers and health workers.
- Careful deployment and management of service providers, to avoid underutilization.
- Maximum use of nonsalary incentives to make public sector positions attractive, especially in rural areas.
- Selective salary adjustments for the highest-skilled workers (such as doctors) in the public sector, to restrain migration.
- Cost-effective investments in medical, nursing, and teacher training capacity, to complement the shorter-term strategies above.

Donors have an important role to play in addressing the health worker crisis. Developed countries that benefit from African-trained medical personnel can help finance expanded training facilities in home countries and assist those countries in recouping medical students' loans.

MOBILIZING FLEXIBLE AND PREDICTABLE FINANCING

Developing countries have increased budget allocations to education and health, but many need to go further to achieve the MDGs. For education, 20 percent of the recurrent budget is the benchmark under the Education for All Fast Track Initiative (FTI)—while Sub-Saharan countries average 15 percent. For health, in 2000 African governments set a target of 15 percent of the recurrent budget, well above their current average of 8 percent.

But allocating more from countries' own fiscal resources will not be enough: A substantial increase in external financing is required. Achieving the universal primary education MDG in low-income countries will require at least \$3 billion a year in additional external financing. Much more is needed to meet the health goals—at least \$25 billion a year. Equally important are deep changes in the nature of donor support. A significant share of bilateral assistance falls outside national planning and budgeting processes. Transaction costs severely strain countries' limited administrative capacity. Aid flows are often volatile. And there is often a disconnect between the types of expenditures that countries need to finance to scale up education and health services—recurrent, local, largely personnel costs—and what bilateral donors provide—in-kind financing, technical assistance. Roughly two-thirds of aid for education is extended as technical assistance.

Flexible and predictable financing is especially important for these recurrent cost-intensive services. Priorities for improving the delivery of financing for these services include:

- *Making aid flexible.* All aid should support priorities identified in PRSs and endorsed sector plans. In countries that meet public expenditure management thresholds, more aid should be provided as budget support.
- *Creating a stable funding framework for the Fast Track Initiative.* To strengthen the FTI, partners should make monitorable, public, long-term commitments to annual increases in funding for primary education. The target should be a significant increase from each partner's 2005 base, which the FTI Secretariat should monitor. Annual funding commitments should help fill agreed financing gaps for endorsed countries where partners have a presence or interest; any residual should be allocated to the FTI's Education Program Development Fund or Catalytic Fund.
- *Aligning global health initiatives with national policies and priorities.* Additional external resources are needed to prevent

and treat childhood diseases, reduce maternal mortality, expand HIV/AIDS treatment, and make progress against malaria and tuberculosis. Increases in donor funding must be long-term and aligned with country priorities. The international health community urgently needs to look at all options for ensuring that global programs organized around specific health interventions do not undermine the coherence of country health strategies, the balanced allocation of resources, and the strengthening of health systems. While preserving the mandates these programs have for mobilizing resources, raising awareness, monitoring results, and financing global public goods with respect to individual diseases, these functions must be better coordinated at the global level and better aligned at the country level with government-led sector plans, with harmonized procurement, disbursement, and reporting procedures. The High Level Forum for the Health MDGs, established in 2003, offers a platform for this collaborative rethinking of the global health architecture and the development of common principles and standards of good practice for engaging global health partnerships at the country level.

IMPROVING MANAGEMENT OF THE SERVICE DELIVERY CHAIN

Sound expenditure management and a focus on development results are crucial to effective service delivery. The realization of increased aid, especially in the form of flexible budget support, also depends on them. Sound expenditure management requires systems for budget formulation, allocation, and reporting that meet threshold standards of integrity and efficiency. In a number of countries in greatest need of external support for recurrent costs, these systems are too weak to give donors confidence that resources can be tracked and used well. Donors are giving high priority to building capacity in this area, but progress depends crucially on domestic commitment to reform.

A focus on development results requires the capacity to gather and analyze real-time data on MDG progress. Countries need to be able to track the primary completion rate and use regular household surveys and sentinel monitoring to generate data on child and maternal mortality and major communicable diseases. Since these indicators improve relatively slowly, intermediate indicators of progress are also important—as are measures of system efficiency, such as those for education developed by the FTI. A similar framework is being developed by the Health Metrics Network, a donor consortium in health. Progress also requires a better evidence base for policy, built on rigorous impact evaluation of key programs.

Ultimately, strengthening service delivery and ensuring that services reach poor people require action to improve the core accountability relationships identified in the *World Development Report 2004*: responsiveness of governments to citizen demands through the political process; responsiveness of service providers to clients; and effectiveness of government agencies in turning resources into results.⁴ Weaknesses in these accountability relationships can be the deepest threat to effective service delivery. But countries are making progress. Sector management can be helped by clear funding norms, competency-based recruitment, results focus, attention to cost-effective standards, and strategies to make effective use of the private sector. Above all, governments can strengthen the voice of clients at the point of service delivery—through the power of information, direct involvement in school and health facility monitoring and management, and the use of conditional cash transfers.

Realizing the Development Promise of Trade

THE DOHA DEVELOPMENT AGENDA

Improving market access for developing countries would provide a major boost to economic growth and progress toward the MDGs. Multilateral, reciprocal, nondiscriminatory trade

liberalization offers the best means for realizing the development promise of trade. A timely, pro-development outcome to the Doha Round is therefore crucial. Based on developments to date, there is a significant risk that a limited, “business as usual” outcome may emerge. Not only would such an outcome greatly reduce the potential of trade to help achieve the MDGs, it could imply a further erosion of the multilateral trading system.

The 2001 Doha ministerial declaration put development at the center of the trade reform agenda. The international community must raise the level of its ambition with respect to the Doha Round and aim for an outcome equal to that vision. High-income countries must lead by example. Efforts should focus on a major reduction in market access barriers—particularly a transformation of agricultural trade policy in high-income countries. Taking into account both tariff and nontariff measures, trade policy in high-income countries is more than seven times as restrictive in agriculture as in manufacturing. Ambitious reference points would be helpful in guiding the negotiations, including:

- *Agriculture*: reducing all agricultural tariffs to no more than 10 percent, eliminating agricultural export subsidies, and fully decoupling domestic agricultural subsidies and rural support from production.
- *Manufacturing*: eliminating tariffs on manufactured products.
- *Services*: committing to free cross-border trade in services delivered over telecommunications networks, complemented by actions to liberalize the temporary migration of service providers.

For these actions to assist in attaining the MDGs, they should be completed by 2015, with major progress achieved by 2010.

Significant trade policy commitments by developing countries are an essential, and equally urgent, part of the agenda to realize the potential of trade for development, including tapping the considerable scope for expanded trade among them. Trade

restrictions are generally much higher in developing than developed countries, and are highest on average in Sub-Saharan Africa, South Asia, and the Middle East and North Africa.

An ambitious Doha Round would yield large gains for the world as a whole and for developing countries. Most estimates place the gains from such an outcome at more than \$250 billion a year by 2015, with 33–40 percent accruing to developing countries—more than their 20 percent share of world GDP. This would imply a boost to the GDP of low-income countries of about 2 percent and that of Sub-Saharan Africa of 1.3 percent; corresponding estimates for a low-ambition, business-as-usual Doha outcome are 0.3 percent and 0.1 percent, respectively. More than three-fifths of the estimated global gains are related to reform of agricultural trade. The estimates of gains are from merchandise trade reform only, and capture mainly static gains. Significant liberalization of services could increase the gains considerably—by a multiple on some estimates.

AID FOR TRADE

Complementing an ambitious Doha outcome, aid for trade should be scaled up substantially. For many low-income countries, fully capturing the opportunities arising from improved market access, as well as their own trade reforms, requires addressing the behind-the-border constraints on their trade capacity. This applies particularly to the least developed countries, most of which are in Africa, for whom lack of trade capacity and competitiveness is the binding constraint. The agenda includes improving trade logistics and facilitation, strengthening critical trade-related infrastructure (such as transport), and further reforming policies that create anti-export bias.

A host of diagnostic trade integration studies undertaken for least developed countries under the Integrated Framework for Trade-Related Technical Assistance have identified areas where aid can be used to build trade capacity. The Integrated Framework, a collaborative venture among multilateral agencies,

bilateral donors, and governments of least developed countries, offers a mechanism to identify priorities and allocate additional assistance to trade-related investments and support for policy reforms. Resources provided to the Integrated Framework to date have been able to support only small-scale technical assistance. But the framework offers a ready-made vehicle for boosting aid for trade, supported by increased integration of the trade capacity building agenda by countries in their PRSs.

TARIFF PREFERENCES

Recent policy in OECD countries has emphasized tariff preferences for small, poor countries—mainly the least developed countries and Sub-Saharan countries. While actions to make existing tariff preferences more effective—for example, through adoption of common, liberal rules of origin—would be beneficial in the short run, in the long run the focus should shift toward alternative forms of trade assistance that generate greater benefits for recipients and are less trade-distorting. Tariff preferences have been of limited value to many African countries and have negative effects on the functioning of the global trade system. Alternative measures include stepped-up financial assistance to strengthen trade capacity and help countries deal with the adjustment costs of trade policy reform, including preference erosion and revenue losses. They also include action by major importers to minimize the incidence of nontariff measures (quotas, licensing requirements, health- and safety-related product standards) on exports from poor countries. Regardless of their intent, regulatory product standards applied at the border have a major restrictive impact on trade and affect poor countries disproportionately. Reducing their incidence on these countries, including by assisting in building their capacity to meet the regulatory requirements, would have a high payoff.

REGIONAL INTEGRATION

Regional trade agreements can also help leverage trade for development—provided they do not detract from the pursuit of an

ambitious Doha outcome. Full realization of the development contributions of both North-South and South-South regional integration arrangements requires that developing country members of these arrangements implement significant liberalization on a nondiscriminatory basis, in addition to granting preferential access to partner countries. Because a number of Sub-Saharan countries still rely on import duties for a significant portion of government receipts, revenue concerns and the ability to put in place alternative revenue sources are factors in determining the appropriate speed of liberalization. Agreements that the European Union and the United States are negotiating with developing countries can do much good if designed in a way that puts development considerations at the center.

Increasing Aid and Its Effectiveness

SCALING UP OFFICIAL DEVELOPMENT ASSISTANCE

Developing countries must make stronger efforts to mobilize more domestic resources to accelerate progress toward the MDGs—moving more vigorously to spur economic growth, strengthening revenue administration, and improving the efficiency of spending. They must also build on reforms that enhance their ability to attract private nondebt capital inflows, especially foreign direct investment. Moreover, in many countries worker remittances are becoming an increasingly important source of private external finance.

Still, for most low-income countries official development assistance (ODA) remains a major source of external finance—and for poor and least developed countries it remains the predominant source. In Sub-Saharan Africa, home to most of these countries, official flows account for about two-thirds of capital inflows. Even with stronger efforts to mobilize more domestic resources and attract more private capital inflows, these countries will need a substantial increase in ODA to improve their prospects for achieving the MDGs. In middle-income countries aid plays

a much smaller but still important role, by catalyzing reforms, supporting efforts to tackle concentrations of poverty, and helping to counter negative shocks.

Donors are beginning to respond to the need to increase aid, following up on their Monterrey commitments. Aid volumes have been recovering since 2001, following a decade of almost continuous decline. Between 2001 and 2003 net ODA increased by 12 percent in real terms. This is encouraging, but aid remains well short of what poor countries need and can use effectively. At least a doubling of ODA is needed within the next five years to build sufficient momentum in progress toward the MDGs. Further increases will likely be needed beyond that period up to 2015. The need for more ODA is especially great in Sub-Saharan Africa—and analysis suggests that, provided countries continued and strengthened policy and institutional reforms, the region could effectively use a doubling of aid over a five-year timeframe.

To signal that needed resources will be forthcoming, 2005 is an opportune time for donors to raise their initial post-Monterrey commitments and extend them over a longer horizon—2010 or beyond. Only half of Development Assistance Committee (DAC) donors have announced aid commitments beyond 2006. The others should do so in 2005.

While aid volumes are rising, it is important to ensure that development aid to poor countries to support their efforts to achieve the MDGs is not crowded out by donors' strategic and security objectives. Large amounts of aid have recently been committed to geopolitically important countries. A better balance in aid is needed, focusing more on poverty reduction. Reducing poverty and the hopelessness that comes with human deprivation is perhaps the most effective way of promoting long-term peace and security. And it costs less: doubling ODA would amount to less than one-tenth of what high-income countries devote to military spending. It is also eminently affordable, representing only about 0.2 percent of high-income countries' gross national income (GNI).

ALIGNING AID WITH ABSORPTIVE CAPACITY

Both how aid is allocated across countries and how increases are sequenced within countries must be aligned with recipients' absorptive capacity. Country readiness to use significant increases in external assistance varies considerably. Which countries should be "fast tracked" depends on the robustness and strength of ownership of development programs articulated in their PRSs and on progress in governance and institutional capacity to implement them, and should be approached on a country by country basis through the normal dialogue between donors and recipients.

A number of low-income countries, including several in Sub-Saharan Africa, have demonstrated the capacity to effectively manage a scaling up of development efforts supported by external assistance. Examples include Tanzania's scaling up of primary education, Indonesia's rapid development of rural infrastructure in its *kecamatans*, Uganda's accelerated expansion of poor people's access to primary health care and of programs to combat HIV/AIDS, Mozambique's transformation of its growth performance by harnessing significant aid flows in support of stepped-up domestic reforms and investments, and Vietnam's rapid reduction of poverty and of the incidence of scourges such as malaria. Recent detailed work on absorptive capacity in Ethiopia, carried out by the World Bank in cooperation with the government, shows the feasibility of substantial increases in aid in support of the MDGs being used effectively—but also underscores the importance of appropriate sequencing of aid to minimize costs and ensure desired development results. There are also many countries where absorptive capacity is weak and increases in aid need to be more measured. Absorptive capacity is neither static nor exogenous to aid; aid can be instrumental in expediting the buildup of capacity.

TAILORING AID TO THE NEEDS OF LICUS

Support for capacity building is particularly important for LICUS. Appropriately timed and

directed aid can be effective in these situations. Key elements of effective support are appropriate sequencing of aid within a long-term engagement (rather than a stop-go or quick-in, quick-out approach) and use of instruments and delivery mechanisms responsive to specific local conditions while supporting the longer-term buildup of national institutional capacity. Well-timed aid can also be quite productive following adverse exogenous shocks, helping to limit the diversion of development resources into short-run relief efforts.

RAISING AID QUALITY

Increasing the quality of aid is just as important as increasing its quantity. As noted above in relation to the financing of human development services, aid is often fragmented and volatile, aligned more with donor agendas and preferences than country priorities, and entails high transaction costs. These issues are receiving more attention and progress is being made, but it has been slow and uneven. The outcome and follow-up to the Second High Level Forum on Aid Effectiveness, held in Paris in March 2005, must lead to a significant step-up in progress. Key areas for attention are achieving closer strategic and operational alignment with country-owned and -led strategies (PRSs or other national development strategies), improving the predictability of aid (including making longer-term commitments when recipient performance warrants it), and strengthening the focus on development results. The Paris Declaration on Aid Effectiveness, which aims for improvements in these and other areas, must be implemented firmly and expeditiously. A notable outcome of the Paris Forum was the adoption of a set of indicators of aid quality that should help with closer monitoring of progress and reinforcement of donor and recipient responsibilities.

DEBT RELIEF

For heavily indebted poor countries (HIPC), debt relief is important for increasing the fiscal space for much-needed increases in spending to promote growth and reduce poverty

and for relieving the debt overhang. Continued and effective implementation of the HIPC Initiative remains key. The Executive Boards of the IMF and the World Bank have endorsed key elements of a debt sustainability framework for low-income countries that would support these countries in their efforts to achieve the MDGs without creating future debt problems and keep countries that have received debt relief under the HIPC Initiative on a sustainable path. With respect to recent proposals for additional debt relief, efforts should be made to reach closure in 2005. Any additional debt relief should not cut into the provision of needed new financing, which for these countries should be primarily in the form of grants. Nor should it undermine the financial viability of international financial institutions. Recent steps to increase the share of grants in concessional financing from the International Development Association (IDA) and other multilateral development banks and to link the mix of grants and loans to recipients' debt sustainability represent notable improvements in the framework for assisting poor countries.

INNOVATIVE FINANCING MODALITIES

The year 2005 should also see progress on ongoing work assessing the merits and feasibility of innovative modalities for mobilizing resources to fund the needed increases in aid and ensure their timely availability, including the proposed International Finance Facility and global taxes related to important international externalities, such as carbon emissions. Blending arrangements, which combine flows with different financial terms and characteristics to increase concessional-ity or gain leverage, also offer possibilities to augment resources for the MDG agenda, including in middle-income countries with large pockets of poverty, and to finance global and regional public goods. Finally, the impressive scale of private contributions in response to the recent Asian tsunami, and major private contributions to causes such as combating HIV/AIDS, point to the importance of exploring ways to enhance the role

and effectiveness of voluntary contributions in supporting development.

Strengthening and Sharpening Support from International Financial Institutions

How are international financial institutions (IFIs)—multilateral development banks (MDBs) and the International Monetary Fund—contributing to implementation of the above agenda, by supporting country development, drawing on sectoral, regional, and global programs and research, strengthening partnerships, and managing for development results? The report finds that there has been progress in each of these areas, but there is a need to do more and pick up the pace.

Low-Income Countries

Recent replenishment negotiations for the African Development Fund (AfDF), Asian Development Fund (AsDF), and IDA endorsed a common framework for the use of PRSs that reflect the MDGs, grants, debt sustainability, and disclosure of country policy and institutional assessments. They also supported piloting of results-based country strategies, adoption of results measurement systems, and special programs for low-income countries under stress. Given that these replenishments cover some 95 percent of MDB programs in low-income countries, they have established a concrete platform for accelerating implementation of these initiatives and harmonizing them across the banks. Support for countries in the event of exogenous shocks is also being strengthened. Reflecting independent evaluations, the World Bank and the IMF need to support stronger country leadership of the PRS process while deepening the dialogue with countries on the policy agenda. Clearer ownership of the PRS by countries, with the Bank and the IMF reflecting their views in Joint Staff Advisory Notes and related process, would also help clarify the accountabilities of Bank and IMF staff.

Middle-Income Countries

For middle-income countries there has also been a trend toward harmonization across the MDBs, albeit slower, reflecting the evolving and varying needs of these countries. Middle-income countries have been vocal in calling for reductions in the costs of doing business with the banks, especially when those costs arise in the context of replenishment exercises for concessional funds that they cannot access. Competitive pressures among the banks have led to the transmission of innovations in one—such as liberalization of expenditure eligibility categories for investment lending or increased reliance on country systems—to the others in fairly rapid succession.

Knowledge and Capacity Building

Research by IFIs has helped to articulate the global development agenda, making notable contributions on trade and aid, among other areas. These institutions have also contributed much to building trade capacity and enhancing countries' fiduciary and fiscal systems for the absorption of aid. But they need to do more—including systematically keeping track of where capacity gaps are, as a basis for guiding donor actions—if developing countries are to fully exploit the opportunities emerging from the dismantling of trade barriers and increasing the scale and effectiveness of aid proposed above.

Partnerships

The MDBs are partnering more effectively with clients, with each other, and with other donors. This progress is largely due to the developments cited above with respect to the replenishments of the banks' concessional windows and their greater reliance on country systems to process their funding. Relative to civil society, disclosure remains a major issue, because despite improvements many critics feel that IFIs have not met a standard of accountability commensurate with their power and influence in a number of areas.

World Bank–IMF relations have continued to mature, based on comparative advantage and a mandate-driven division of labor highlighted by ongoing collaboration on PRSs, debt sustainability analysis and its application to concessional and grant financing, and further streamlining of structural conditionality.

Managing for Development Results

During 2004 important milestones were achieved in building results-based systems in the MDBs. These include the completion of the first cycle of the IDA13 results measurement system, the adoption of the IDA14 and AfDF X results measurement systems, the completion of results-based country strategy pilots by the Asian Development Bank and the World Bank (and their commitment, along with the African Development Bank's, to conduct further pilots in 2005), the Inter-American Development Bank's adoption of a Medium-Term Action Plan for Development Effectiveness, the new independence of the Asian Development Bank's evaluation department, the launch of the draft *Results Sourcebook* prepared jointly by these institutions and bilateral donors, and the major PRS evaluations carried out in cooperation by the World Bank's Operations Evaluation Department (OED) and the IMF's Independent Evaluation Office (IEO). The IMF is considering how to conceptualize and operationalize the results agenda within its institutional framework, drawing on recommendations from various reports of the IEO.

Priorities for Action

How can IFIs strengthen and sharpen their support? This report suggests five priorities for action and monitoring progress:

- Support the deepening of the PRS framework in low-income countries, and the operationalization of the MDGs and alignment of IFI assistance within that framework. Support for building institutional capacity is especially important for low-income countries under stress.

- Continue to adapt approaches and instruments to better respond to the evolving and varying needs of middle-income countries, including further streamlining of conditionality and investment lending.
- Ensure that the implications of dismantling trade barriers and increasing the scale and effectiveness of aid are adequately reflected in support for country capacity building, so that emerging opportunities can be fully utilized. International financial institutions should sharpen the strategic focus and improve the effectiveness of their support for global and regional public goods.
- Strengthen partnerships and harmonize further by improving transparency, reducing red tape and enhancing the flexibility of assistance (through simplification and use of sectorwide approaches), and promoting the development and use of country systems—for procurement, financial management, and environmental assessment.
- Strengthen the focus on results and accountability by supporting country efforts to manage for development results (strengthening public sector management and development statistics) and furthering progress within IFIs on enhancing the results orientation of their

country strategies and programs and quality assurance processes. In addition, a common framework should be adopted for self-evaluation of MDB performance and results measurement, and adapted to IMF operations as much as possible.

Notes

1. The MDGs flowed from the Millennium Declaration adopted by 189 countries at the United Nations Millennium Summit, held in New York in 2000. The Monterrey Consensus emerged from the UN Conference on Financing for Development, held in Monterrey, Mexico, in 2002.

2. UN (2005); UNMP (2005); Commission for Africa (2005).

3. The *Global Monitoring Report 2004*, prepared for the Spring 2004 Development Committee meeting and published in June of that year, provided a comprehensive assessment of the policy agenda for achieving the MDGs and related development outcomes, spanning the responsibilities, as reflected in the Monterrey Consensus, of all the key actors—developing countries, developed countries, and international financial institutions. Building on that analysis, this report has a more selective focus on key areas of the policy agenda but provides a more in-depth assessment of those areas.

4. World Bank (2003).

Spurring and Sustaining Economic Growth

Economic growth is central to reducing poverty and meeting the Millennium Development Goals (MDGs). Globally, prospects are promising for halving income poverty—the first goal—by 2015. The two countries that in 1990 were home to the most poor people, China and India, have accelerated economic growth for sustained periods and made significant inroads into reducing the incidence of poverty. Due partly to their efforts, East Asia has already achieved the poverty goal, and South Asia is on target. Most other developing regions are making steady progress and are expected to either achieve the goal or come close, even as pockets of poverty remain at the national and sub-national levels. But in Sub-Saharan Africa the momentum has been slower, and most countries are at severe risk of falling short.

To accelerate progress toward the poverty goal, Sub-Saharan Africa will need to substantially boost economic growth. Increases in a country's overall income tend to lift the income of its poor people proportionately, and there is little doubt that differences in policies and institutions have played a major role in explaining the divergent poverty trends seen, for example, in East Asia and Sub-Saharan Africa. The growth process in Africa, although subject to some initial disadvantages such as difficult geography and

high incidence of disease, responds to key policy drivers in a manner fundamentally similar to economies elsewhere. Thus the promotion of higher growth rates through policy and institutional reforms is critical for poverty reduction (box 2.1), and outlining the agenda for spurring and sustaining growth in Sub-Saharan Africa is the focus of this chapter.

Recently there has been evidence that Sub-Saharan Africa is starting to turn the corner. Twelve countries are experiencing a growth acceleration of the type more commonly associated with other regions. More generally, improvements in economic policies and political institutions have supported higher growth rates across the region. But these achievements are only the beginning of what is needed to sustain needed improvements in income levels and living standards. It is considerably more difficult to sustain growth than merely to initiate it.

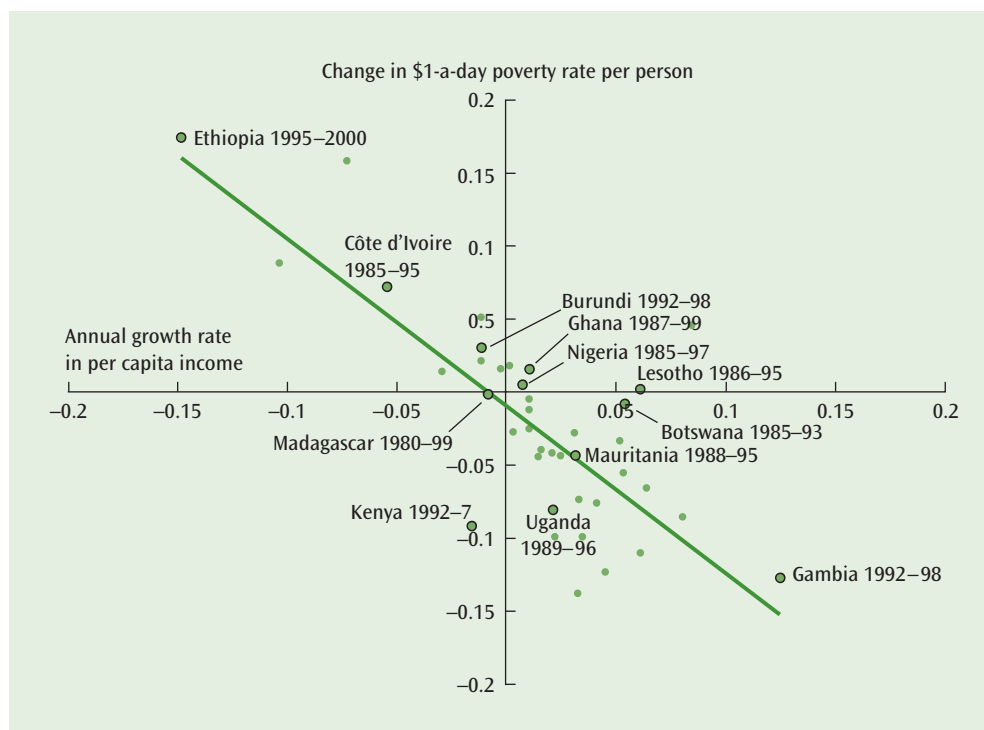
Sub-Saharan Africa's weak economic performance over the past four decades, and its difficult prospects for reaching the MDGs, have led some analyses to conclude that many African countries are caught in "poverty traps." The suggestion in these analyses is that large amounts of aid are needed to jumpstart growth across the region. But increased aid is insufficient to spur and sustain higher

BOX 2.1 Growth is central to sustained poverty reduction

The strong relationship between income growth and poverty reduction has been documented in a large empirical literature. This relationship can also be seen in the figure below, which shows changes in poverty over the past two decades—using the \$1 a day headcount measure—for a large sample of developing countries. (For details on the data and decomposition methodology used in this box, see Kraay, forthcoming.) The figure also indicates wide variation around this average relationship. What implications do these differences have for poverty reduction?

Consistent with other developing regions, most countries in Sub-Saharan Africa are clustered in the top left quadrant (with negative growth and rising poverty) or bottom right quadrant (with positive growth and declining poverty). Sub-Saharan countries have a median per capita growth rate of 0.8 percent a year, substantially lower than the overall median of 2.1 percent, and most fall above the regression line, indicating worse poverty reduction performance than for a typical developing country with similar growth performance.

The figure also indicates important differences across countries in the rate at which poverty declines for a given growth rate. Ghana, and Uganda, for example, had similar annual growth rates (1–3 percent), but their rates of annual change in poverty ranged from about –8 percent to +2 percent. There are two reasons for such differences: cross-country differences in the sensitivity of poverty to growth, holding constant the distribution of income; and cross-country differences in how the distribution of income changes over time.



Note: Sub-Saharan countries are labeled, including the years of the change in poverty.

Regression line shown: $y = -1.15x - 0.01$; $R^2 = 0.54$

BOX 2.1 Growth is central to sustained poverty reduction (*Continued*)

Sub-Saharan countries tend to have a low sensitivity of poverty to growth, and the contribution of changes in inequality to changes in poverty in the region is similar to that in the developing world as a whole. Together these findings suggest that poverty reduction in Sub-Saharan Africa has been disappointing primarily because of its slow growth and low sensitivity of poverty to growth (holding constant the distribution of income). This low sensitivity can be traced to the region's low incomes and high inequality. (Sub-Saharan Africa and Latin America are the world's most unequal regions.)

What are the implications for policy? At a basic level, growth remains crucial for reducing poverty in Africa—all the more so given that the region's low income levels imply a relatively low sensitivity of poverty to growth. Moreover, the dominance of growth as the driver of changes in poverty seems to be even clearer over longer periods, suggesting that growth is especially critical for sustained reductions in poverty. Finally, evidence does not suggest that policy and institutional reforms aimed at promoting growth lead to higher inequality, which would temper the poverty impacts of growth.

Recent case studies on the factors driving pro-poor growth in 14 developing countries confirm the importance of macroeconomic reforms, followed by substantially higher growth without any short-term increase in the Gini coefficient. During the first five years of economic reforms, annual per capita growth rose by 2.0 percentage points in Burkina Faso and 4.5 points in Uganda. During the same period the Gini coefficient fell from about 0.47 to 0.45 in Burkina Faso. Although lack of pre-reform data preempts a similar comparison for Uganda, a relatively low post-reform Gini coefficient of 0.36 does not raise serious concerns about rising inequality.

Source: World Bank 2004; Dollar and Kraay 2002; Ghura, Leite, and Tsangarides 2002; Lopez 2004.

growth—and its provision by itself does not constitute a growth strategy. While certain forms of aid do appear to raise growth rates, the effects can be relatively small and are subject to diminishing returns. There is also no systematic evidence supporting the empirical relevance of poverty traps.

The policy agenda discussed in this chapter is daunting in its breadth, complexity, and ambition. It would be useful to describe the minimum set of reforms required to spur growth, or the larger set sufficient to sustain it. But neither is possible: the relationship between growth and policies, aid, shocks, the external environment, and other factors is complex. The policy recommendations in this chapter reflect a wealth of cross-country, time series, and case study experiences. Yet growth often occurs in countries where several of these mechanisms are not in place. Similarly, countries

may undertake substantial reforms and observe disappointing growth payoffs for a while. With respect to growth accelerations, for example, occurrences are both fairly common and hard to explain—though both policy and institutional improvements help extend these episodes.

The priorities emphasized in this chapter are macroeconomic stability, and institutions and policies that promote private sector growth. For countries that have achieved broad macroeconomic stability, better expenditure management is critical to sustaining it and creating fiscal space for investments aimed at promoting growth and reducing poverty, including those that complement private activity. To invigorate the private sector and encourage a wider range of profitable opportunities to be taken up, it is essential to remove excessive regulatory and institutional constraints and improve weak infrastructure.

To underpin these efforts, recent progress on political governance must begin to be translated more clearly into progress on economic governance. Better economic governance is important for improving the private sector environment and increasing public sector effectiveness. Transparency in its various dimensions is a theme underlying many of the interventions identified here. Trade liberalization is also a policy priority in many countries (see chapter 4).

This discussion of priorities is inevitably broad because, in the end, the best path will be tailored to each country. While there are many similarities, different countries face different problems to different degrees. Equally important, the relationship between different aspects of reform will vary across countries. Progress must occur on a number of fronts, and the key areas will differ by country. In many cases, trade liberalization will create possibilities for reform in other areas. In others, improvements in the regulatory environment will have an important impact. In still others, improving the regulatory environment or even achieving macroeconomic stability will depend on improving public sector governance. Countries must adapt the recommendations in this chapter, in terms of form and sequence, to their own circumstances, in the context of country-owned poverty reduction strategies. Still, the priorities and progress indicators described here should help in determining the direction of reforms and assessing progress.

In Sub-Saharan Africa, home to most low-income countries under stress (LICUS), the road ahead is not easy, and there is a need for bold action. Within the agenda outlined above, there is substantial room for enabling virtuous circles. For example, as credible evidence of a change in the macroeconomic policy regime takes hold, the uncertainty attached to fixed investments begins to decrease—and as more investors consider taking up profitable opportunities, the demand for a better investment climate increases. Because there will remain vested

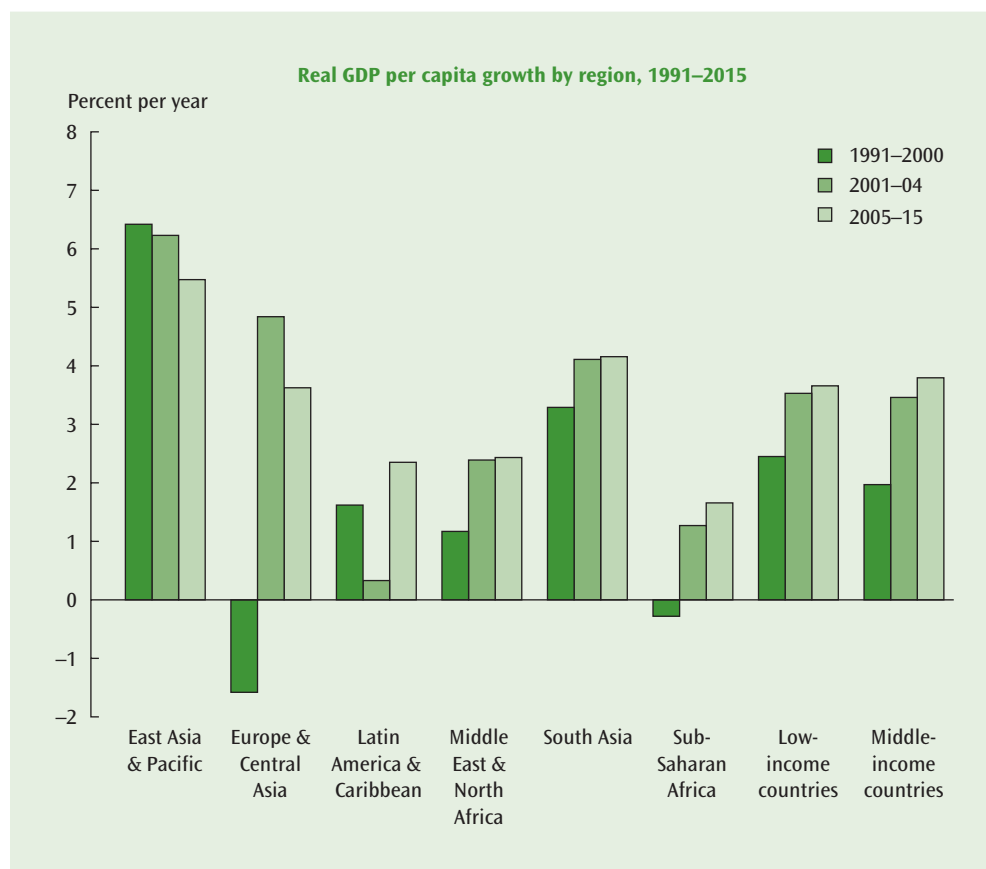
interests intent on maintaining the status quo, political commitment is key to initiating and sustaining reforms.

The scale of the challenge in Sub-Saharan Africa means that domestic efforts will require external support. Large increases in aid will be needed, particularly to accelerate progress toward the nonincome MDGs (see chapter 3). Better access to the markets of developed countries is needed to promote and diversify exports (chapter 4), and external debt levels must be sustainable to ease the burden on fiscal policy (chapter 5).

The first section of this chapter provides the context for the discussion of the growth agenda by reviewing medium-term projections for growth and poverty rates, analyzing Sub-Saharan Africa's record of economic performance, and identifying conditions that have historically accompanied the onset of, and tended to sustain, periods of growth acceleration. The subsequent sections focus on the three key elements of the growth agenda: the macroeconomic environment, the private investment climate, and public sector governance.

Growth and Its Implications for Poverty

The overall outlook for growth remains promising over the next decade (figure 2.1).¹ Strong growth should continue in East Asia even as China's spectacular growth rates ease, and in Europe and Central Asia as the benefits of EU accession continue for several countries in the region. Elsewhere, ongoing reforms should ensure a better investment climate and stable macroeconomic environment—particularly in South Asia, where the average annual increase in per capita income is expected to exceed 4 percent over 2005–15.² After various difficulties in recent years, including contagion from Argentina's long crisis, per capita growth in Latin America is expected to average nearly 2.5 percent a year. Although Sub-Saharan Africa's performance has improved since the mid-1990s (see below), the region continues to lag in terms of economic growth.

FIGURE 2.1 Growth prospects are promising, but wide regional disparities remain

Source: World Bank staff estimates.

If these projections hold, the income poverty MDG will be achieved globally. Worldwide, the poverty headcount index will fall from 28 percent in 1990 to 10 percent in 2015, and the number of people living on less than \$1 a day will fall from 1.22 billion to 622 million (table 2.1). These achievements will largely reflect successes in China and India, which contained most of the world's poor people in 1990 but where income growth has since accelerated and remained high. In Europe and Central Asia, where the rate of poverty is relatively low, the increase in poverty that accompanied the sharp drop in incomes in the early 1990s has been reversed, as it has in Latin America.

Still, many individual countries are not on track to achieve the poverty goal, including most countries in Sub-Saharan Africa. Even in regions with strong overall performance and prospects for achieving the poverty MDG, some countries need to substantially accelerate progress, such as Cambodia and Papua New Guinea in East Asia. In some large middle-income countries the national poverty rate is low, but some subnational regions continue to have large concentrations of poverty, such as inland western provinces in China, some southern states in Mexico, and the northeast region of Brazil.³

In Sub-Saharan Africa, reaching the poverty goal will require a substantial acceleration in

TABLE 2.1 Over the next 10 years growth is expected to rise and poverty fall around the world (percent unless otherwise indicated)

Region	Average annual growth rate, 2005–15		Population living on less than \$1 a day					
			Headcount index			Number of people (millions)		
	Per capita GDP	GDP	1990	2001	2015	1990	2001	2015
East Asia and Pacific	5.5	6.3	29.6	14.9	0.9	472	271	19
China	6.0	6.7	33.0	16.6	1.2	375	212	16
Europe and Central Asia	3.6	3.7	0.5	3.6	0.4	2	17	2
Latin America and the Caribbean	2.4	3.6	11.3	9.5	6.9	49	50	43
Middle East and North Africa	2.4	4.2	2.3	2.4	0.9	6	7	4
South Asia	4.2	5.6	41.3	31.3	12.8	462	431	216
Sub-Saharan Africa	1.7	3.6	44.6	46.4	38.4	227	313	340
Average/total	3.6	4.8	27.9	21.1	10.2	1,219	1,089	622
Excluding China	2.8	4.2	26.1	22.5	12.9	844	877	606

Source: World Bank staff estimates.

income growth or a significant increase in the poverty elasticity of growth. While the recent pickup in growth has improved prospects, the economic stagnation of the early 1990s caused poverty rates—already the highest in the world in 1990—to increase even further by 2001 (figure 2.2). Household surveys, which are available for 28 countries (accounting for 78 percent of the region's population and 87 percent of its GDP), suggest that the weighted average annual growth in per capita income required to achieve the income poverty goal is about 5 percent (table 2.2). Of these countries, Cameroon, Ethiopia, Senegal, South Africa, and Swaziland have a required per capita growth rate of less than 3 percent a year, leaving them well positioned to meet the poverty goal. Also close are Mauritania and Mozambique, where the required per capita growth rate is less than 3.5 percent a year. But together these seven countries contain less than a quarter of the population of Sub-Saharan Africa.

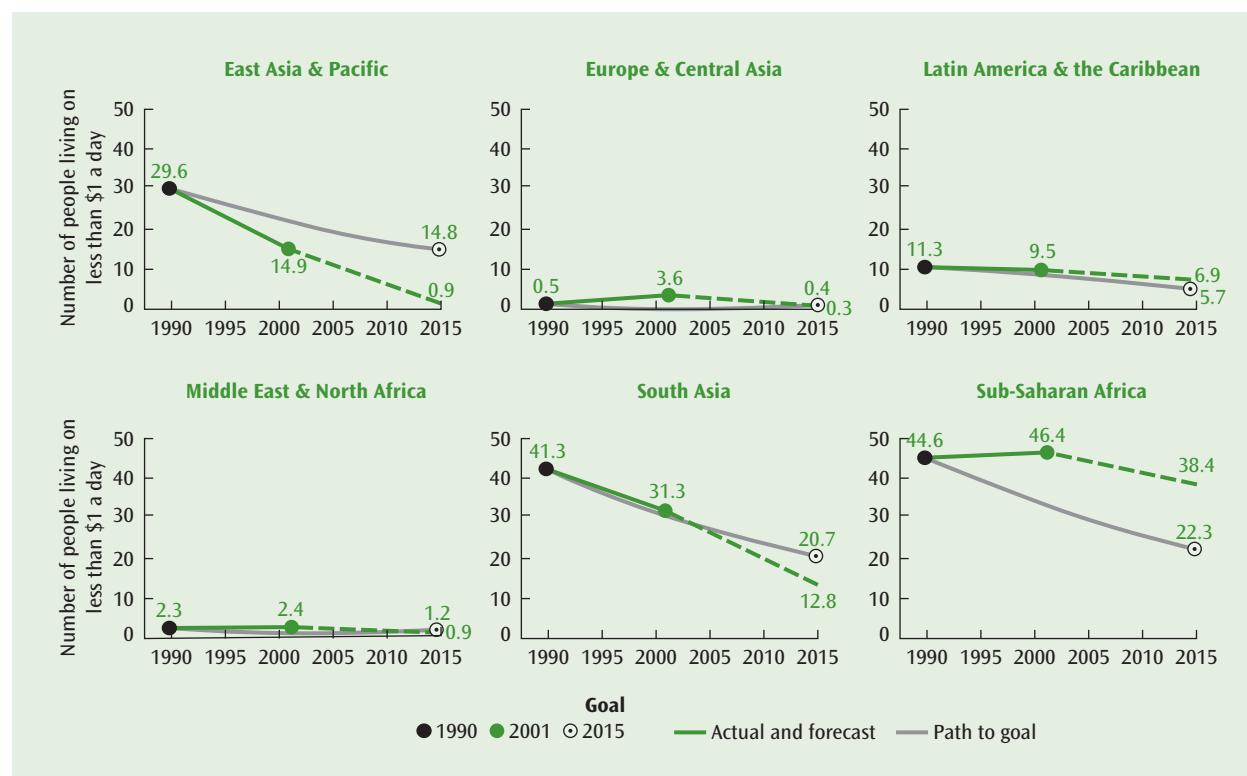
Ensuring that Sub-Saharan Africa makes significant progress toward the income poverty goal will require substantial efforts from countries in the region and all their development partners. For a successful example the region might look to South Asia,

where similar initial disadvantages—including a high incidence of conflict—and similar income levels have not prevented rapid progress toward the MDGs. In South Asia an improving investment climate and stronger policies have sustained rapid economic growth since 1990 and made significant inroads into reducing poverty. Important developments in service delivery, such as provision of basic services by nongovernmental organizations (NGOs) and the private sector, have also contributed to the MDGs in some South Asian countries. Still, sustaining and accelerating economic growth, increasing the effectiveness of public spending, making services work for all people, and dealing with lagging regions and countries remain vast challenges in South Asia (box 2.2).

Africa's Growth Record

Although Sub-Saharan Africa's performance has recently improved, its overall economic record over recent decades presents a somber picture.⁴ Since 1980 real per capita GDP growth has been lower than in other developing regions, and growth rates have been more volatile (figure 2.3).⁵ Of the 45 Sub-Saharan

FIGURE 2.2 Most regions will reach the poverty MDG by 2015, but Sub-Saharan Africa is seriously off track



Source: World Bank staff estimates.

TABLE 2.2 Many Sub-Saharan countries require rapid growth to achieve the income poverty MDG

Required growth of per capita GDP, 2005–15	Number of countries	Population, 2000 (millions)	Share of Sub-Saharan population (percent)	Share of Sub-Saharan GDP, 2000 (percent)
< 2 percent	1	9.5	1	2
2–3 percent	4	124.5	19	52
3–4 percent	2	20.2	3	1
4–6 percent	4	44.4	7	5
> 6 percent	17	315.4	48	27
Total	28	514.0	78	87

Source: World Bank staff estimates.

Note: For the 28 countries in this sample, the weighted average required growth in per capita GDP is 5.2 percent a year.

BOX 2.2 South Asia shows that stronger growth and better service delivery are key to the MDGs

With per capita income averaging \$460 a year, the eight countries of South Asia—Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka—are home to nearly 40 percent of the world's people living on less than \$1 a day. But since 1990 the region has achieved annual GDP growth of nearly 5.5 percent, helping to reduce poverty significantly. For example, India—the region's largest country, with a population of more than 1 billion people—has reduced its poverty rate by 7–10 percentage points since 1990. Most other countries in the region have registered similarly significant reductions. Two notable exceptions are Afghanistan, which is emerging from decades of conflict, and Pakistan, where poverty has stagnated at around one-third of the population.

Improving the delivery of human development and key related services has also been instrumental in boosting MDG-related outcomes and prospects. Three places in South Asia stand out as having especially good MDG indicators for their income levels. Sri Lanka and the Indian state of Kerala have strong records of good performance (similar to those in high-income countries), reflecting the priority that successive governments have long given to investing in human development. And Bangladesh has shown remarkable progress on many of the MDGs despite its low income, high poverty (second only to Afghanistan in the region), adverse initial conditions, high population density, contentious politics, and vulnerability to natural disasters. Bangladesh's success has owed much to an effective scaling up of basic services based largely on partnerships between the public sector and NGOs and a resulting high degree of community involvement, local innovation, and experimentation.

Although reducing poverty remains a huge challenge for South Asia, the income poverty MDG is within reach, as continued high economic growth will raise incomes, widen economic opportunities, and create jobs for poor people. But sustaining rapid growth will require further improvements throughout the region in the investment climate, basic infrastructure, and delivery of basic services within a framework of macroeconomic (especially fiscal) stability.

A number of other MDGs are also within the region's reach if service access and delivery improve for poor people—as shown by the region's success stories. Yet despite substantial public spending, health, education, water, and sanitation services continue to fail poor people in some countries and states. In many cases this is due to the fragile accountability between users, providers, politicians, and policymakers caused by ineffective public institutions, poor focus on outcomes and incentives, political clientelism and patronage, and difficulty of monitoring and supervision. But with democracy firmly rooted across the region, the devolution of political power to lower levels of governments is proceeding. While progress varies, decentralizing resources and responsibilities to local providers and communities holds prospects for better service delivery. Against this backdrop the universal primary education, gender equality, child mortality, and major disease MDGs appear within reach of most South Asian countries, with only Afghanistan, Pakistan, and poorer states in India remaining off track unless progress quickens substantially.

Source: World Bank South Asia Vice Presidency.

countries, only 5 consistently recorded real per capita growth rates above 2 percent a year: Botswana, Cape Verde, Mauritius, Seychelles, and Swaziland.⁶ Moreover, economic disruptions have been widespread, with nearly three-quarters of the region's countries recording at least one year of per capita growth lower than

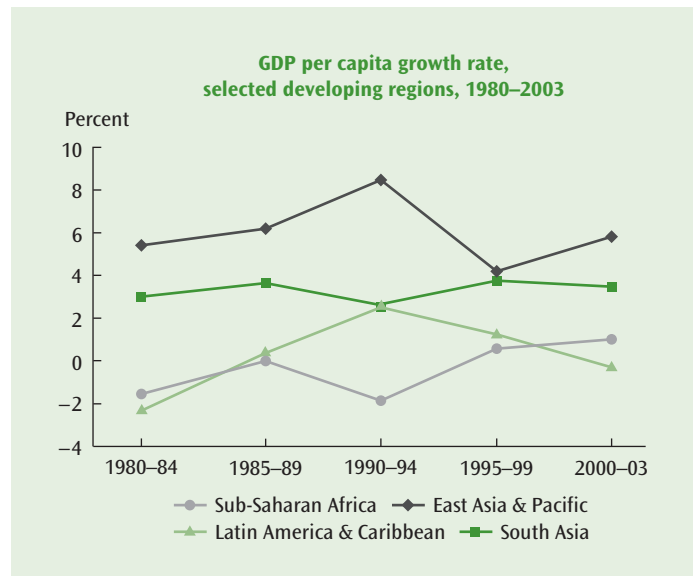
–10 percent. Consequently, Africa's real income per capita has steadily declined relative to other regions, and is roughly the same as in the mid-1970s (figure 2.4).

At the same time, the region's income distributions may have become more unequal. Empirical estimates indicate that inequality in

Africa has increased since 1970, with the income of the poorest people deteriorating but the income of the richest remaining stable. These findings have potentially important political and economic consequences: With the elite buffered from poor economic performance, they are less likely to introduce the reforms needed to improve Africa's outlook.⁷ This problem is perhaps more evident in countries where the elite have a more autonomous source of income, such as oil sector rents.

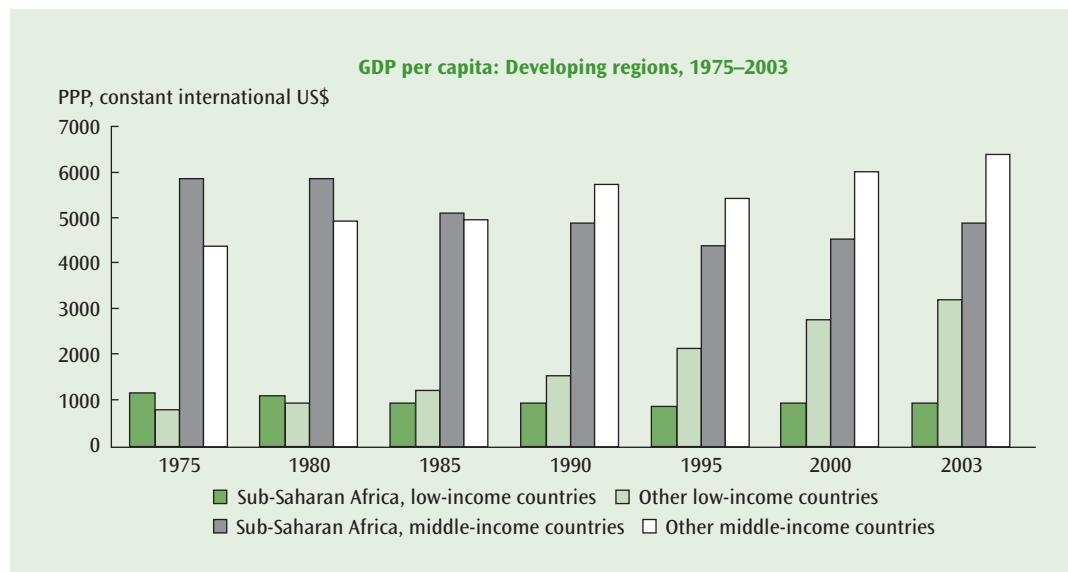
Although factor accumulation rates have been lower than in other regions, negligible improvements in productivity have been the primary source of Africa's slow growth. Since the 1960s the private investment rate has consistently been lower in Sub-Saharan Africa—even when the comparison is restricted to low-income countries in other developing regions (figure 2.5)—and in the 1990s a small number of major oil-producing countries received the bulk of the increase in such investment.⁸ Similarly, modest increases in

FIGURE 2.3 Sub-Saharan Africa has lagged behind other regions



Source: World Bank staff estimates.

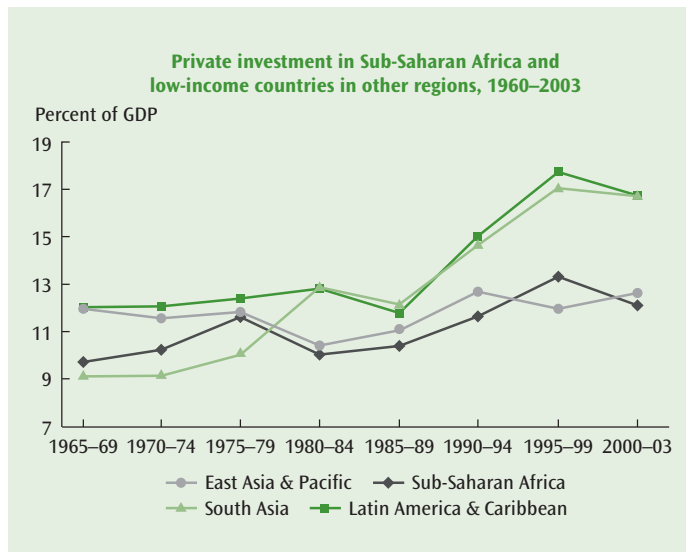
FIGURE 2.4 And the gap in income levels is widening



Source: World Bank World Development Indicators database; and World Bank and IMF staff estimates.

Note: In this figure, income classification groups follow the earliest available World Bank analytical classification (1987), in order to minimize the effects of selectivity bias. The conclusion on a widening gap is robust to the use of classifications for different years.

FIGURE 2.5 Lower investment rates in Sub-Saharan Africa have been a source of low growth



Sources: IMF, *World Economic Outlook*; World Bank, World Development Indicators database; and IMF staff estimates.

education enrollments have implied a smaller contribution from increased human capital than for most other developing regions.⁹ But the key source for the region's weak economic performance was that total factor productivity growth was nonexistent between 1960 and 2002—unlike in other developing regions, where such efficiency improvements played an important role in supporting growth.¹⁰

On a more positive note, since the mid-1990s economic growth has improved to levels last recorded in the region in the early 1970s. Since 1995 more than 15 Sub-Saharan countries have persistently recorded real per capita growth rates above 2 percent a year, compared with only 5 in 1960–94. This improvement has benefited a range of countries, including low- and middle-income countries and even those that recently suffered conflict. On the whole, though, oil-based economies have enjoyed the best performance, with real per capita growth of close to 4 percent a year since the mid-1990s.

What explains Sub-Saharan Africa's poor economic record—and incipient recovery?

On the former, it has suffered, and continues to suffer, from a number of major disadvantages relative to other regions. It has a disproportionately large number of landlocked countries that, given weak regional infrastructure, are unduly dependent on trade with their immediate neighbors. Many countries are heavily dependent on low-value agriculture and therefore vulnerable to climatic fluctuations, including periodic droughts. Its population endures high rates of malaria, HIV/AIDS, and other communicable diseases.¹¹ Since 1970 one-quarter of its countries have experienced civil conflict. And like other developing regions, Sub-Saharan Africa has been handicapped by lack of access for its exports to markets of developed countries and vulnerability to natural disasters and terms-of-trade shocks.

Still, there is a general view that drivers of growth operate in much the same way in Africa as elsewhere.¹² Critically, on the main dimensions of macroeconomic and structural policies as well as the effectiveness of institutions, Sub-Saharan Africa tends to underperform relative to other developing regions. The World Bank's Country Policy and Institutional Assessment (CPIA) ratings confirm that Sub-Saharan Africa achieves a lower average score than other developing regions on each of the main categories assessed: economic management, structural policies, social inclusion and equity policies, and public sector management and institutions. In addition, macroeconomic instability—as measured, for example, by the standard deviation of consumer price inflation or the parallel market exchange rate—has tended to be higher in Africa than most developing regions.¹³ Even when the comparison is restricted to low-income countries in other regions, the quality of macroeconomic policies is still lower in Africa (table 2.3).

Empirical studies confirm that weak macroeconomic policies and governance have had a negative impact on growth in Sub-Saharan Africa. These studies indicate that in recent decades growth could have been significantly

TABLE 2.3 Macroeconomic policies are weaker in Sub-Saharan Africa than in other low-income countries (percentage of countries)

Region/rating	Fiscal policy	Composition of public spending	Monetary policy	Consistency of macro policies	Public sector governance	Governance and transparency in monetary and financial institutions	Trade regime
Sub-Saharan Africa							
Unsatisfactory	42	68	17	30	46	30	14
Good	22	3	72	46	14	52	73
Other low-income countries							
Unsatisfactory	19	57	7	14	26	7	5
Good	48	10	74	55	14	63	86

Source: IMF staff assessments.

Note: Policies are assessed as unsatisfactory, satisfactory, or good. Percentages do not sum to 100 because the intermediate category—satisfactory—is not shown.

raised by better fiscal policies (including lower government consumption and smaller fiscal deficits), policies that promoted human capital formation and private investment, and stronger institutions. Estimates of the additional growth that Africa would have enjoyed with the adoption of policies, institutions, and rates of factor accumulation similar to those in other regions range from 2–8 percentage points a year.¹⁴

One explanation for which there is no systematic empirical evidence is the view that poverty traps explain Sub-Saharan Africa's poor economic record. Proponents of such explanations argue that low productivity and savings rates make it difficult for poor countries to rise past a threshold income level. This logic is plausible, given the persistence of poverty. In general, however, neither macroeconomic nor microeconomic evidence tends to support the existence of such traps. Moreover, there is little evidence of the type of productivity and savings behavior needed at low income levels to generate poverty traps (box 2.3).

Empirical evidence also offers some words of caution on the commonly proposed solution for poverty traps—namely, large external resource transfers. Certainly, large increases in foreign assistance are needed in many Sub-Saharan countries, including to

allow significant increases in key public services (see chapter 5). Moreover, aid increases complement improvements in policy, institutions, and the international environment. But the apparently limited growth impact of aid, combined with its diminishing returns, implies that by itself aid does not constitute a growth strategy.¹⁵

Experiences with oil windfalls in Sub-Saharan Africa in the late 1970s illustrate that increases in public investment driven by foreign inflows are also unlikely, in themselves, to lead to sustained growth. Because of large increases in oil production and prices, countries such as Congo enjoyed large windfalls over nearly 10 years starting in the late 1970s. But the medium-run impact on living standards was negligible at best (box 2.4). This example is particularly relevant because oil rents share many characteristics with and have similar macroeconomic effects as foreign assistance flows.

Since the 1960s Sub-Saharan Africa has also experienced widespread conflict and endured the associated heavy costs (figure 2.6). In the region's low-income countries the typical civil war has lasted about seven years and caused GDP to decline (relative to the counterfactual) by more than 2 percentage points for each year of conflict. It has typically taken

BOX 2.3 Do poverty traps account for Africa's underdevelopment?

A popular and plausible explanation for Africa's persistent underdevelopment is that much of the continent is caught in a trap: Poverty leads to low savings, low investment productivity, poor health, and other features that cause poverty to persist (Sachs and others 2004; Collier 2004). But there is little empirical work testing for poverty traps, and much of what exists tends not to support the hypothesis.

The persistence of poverty across countries is consistent with the hypothesis. A number of papers have documented that over the past 50 years the cross-country distribution of per capita incomes has become bimodal, with a group of countries clustered around quite a low income level. (See Azariadis and Stachurski 2004 for links between models of poverty traps and this kind of empirical evidence; Quah 1993a, 1993b, 1996, and 1997 for the evidence; and Kremer, Onatski, and Stock 2001 for a critique. Bloom, Canning, and Sevilla 2003 also provide closely related cross-country evidence.) Other evidence comes from looking at the dynamics of individual incomes. Many models of poverty traps suggest that individuals receiving large income shocks may take a long time to recover—and if their incomes fall below a certain threshold, they may never recover. But Lokshin and Ravallion (2004) carefully examine household data from Hungary and Russia, and conclude that there is no evidence of the kind of “threshold effects” associated with models of poverty traps.

Reduced-form evidence such as this can demonstrate the persistence of poverty but not the nature of the underlying mechanism that may be creating a trap. Without such information it is difficult to distinguish a poverty trap from persistence in the determinants of poverty, or to formulate an appropriate policy response. Several recent studies have looked for evidence of particular mechanisms generating poverty traps. One such mechanism involves financial market imperfections. If the upfront cost of starting a small business is large, and poor individuals cannot borrow to finance this investment, they will be unable to reap the benefits of self-employment. McKenzie and Woodruff (2004), using data on microenterprises in Mexico, show that the costs of starting such a business are surprisingly small—averaging just two weeks' income for a typical low-wage Mexican worker. This finding casts doubt on the idea that fixed costs, combined with financial frictions, are responsible for poverty traps.

Another possible mechanism is that productivity is low at low levels of development. This may be because it is difficult to reach minimum efficient scales of production, or because complementary investments in public goods (such as infrastructure) are inadequate in poor countries. Once these thresholds are crossed, it is possible that productivity will increase sharply, allowing countries

about 14 years after the end of a conflict for a country to recover to its prewar growth path. In addition, substantial spillover costs undermine economic performance in neighboring countries. In the typical low-income African country, with a purchasing power parity value of GDP of around \$20 billion, the present value of the cost of conflict is about \$50 billion. Most costs arise in the form of externalities, accruing either to people in the future or to neighbors.¹⁶ Crucially, the risk of conflict tends to be strongly affected by low economic performance (box 2.5).

Sub-Saharan Africa's recent recovery has been supported by improvements in key macroeconomic indicators, particularly in the fastest-growing economies, and some strengthening of political institutions. Across the continent, macroeconomic indicators have improved since the mid-1990s: price inflation is at near-historic lows, distortions in exchange rates have been mostly eliminated, fiscal deficits are lower, and export volumes have increased. School enrollments are also increasing, along with budget allocations to both education and health. The percentage of countries holding

BOX 2.3 Do poverty traps account for Africa's underdevelopment? (continued)

to reach much higher income levels. Kraay and Raddatz (2005) embed this mechanism in a standard growth model and show that for this mechanism to generate a poverty trap, productivity must increase (implausibly) sharply with the level of development. In particular, the authors show that if this mechanism is at work, one should expect to see increasing returns to scale much larger than are ever seen in the extensive empirical literature on estimating production functions. Somewhat more directly, McKenzie and Woodruff (2004) find in their Mexican data that returns to investment are very high even for microenterprises.

Poverty traps might also arise because of low savings rates in poor countries. If many households live at the margins of subsistence, they will be unable to save much. In addition, public saving might be low in poor countries because governments have difficulty with tax collection. Low savings rates may translate into such low investment rates that countries are unable to accumulate significant stocks of productive assets per capita. And if savings rates only begin to increase at much higher levels of development, countries that start out poor may be stuck in a poverty trap.

Kraay and Raddatz (2005) confirm that savings rates tend to increase with income—but not in a way that would explain the existence of poverty traps for most African countries. The authors also calibrate a growth model with subsistence consumption and find that the impact on saving and growth is substantial only for countries that start out close to subsistence levels. But the observed dispersion in per capita incomes, which is significant even in a poor region such as Sub-Saharan Africa, implies that the role of subsistence consumption can explain low saving and growth in only a few of the region's poorest countries.

There are also potential poverty traps based on self-reinforcing dynamics in the area of governance. For example, there is evidence that civil wars are both a consequence and a cause of low income, creating the possibility of a conflict trap (Collier and others 2003). There are also reasons to believe that high corruption creates self-perpetuating expectations of future corruption. The role of such mechanisms in generating stable poverty traps in growth models has not been fully studied. But in these cases, large increases in foreign aid might actually be counterproductive, increasing incentives and opportunities for corruption and conflict. Tackling these underlying dysfunctions directly must be done in parallel with any large increases in aid (Collier 2004).

Source: Kraay and Raddatz (2005).

competitive elections has increased, and the incidence of conflict appears to be declining.

Policy improvements since the mid-1990s have been particularly striking among the fastest-growing Sub-Saharan countries. Relative to slower growers, these countries have a much lower average inflation rate, smaller fiscal deficits (despite similar spending levels), and significantly higher trade openness (measured by the share of exports and imports in GDP). Moreover, growth in productivity was a robust 2.4 percent for the fastest growers, compared with close to zero for the others.

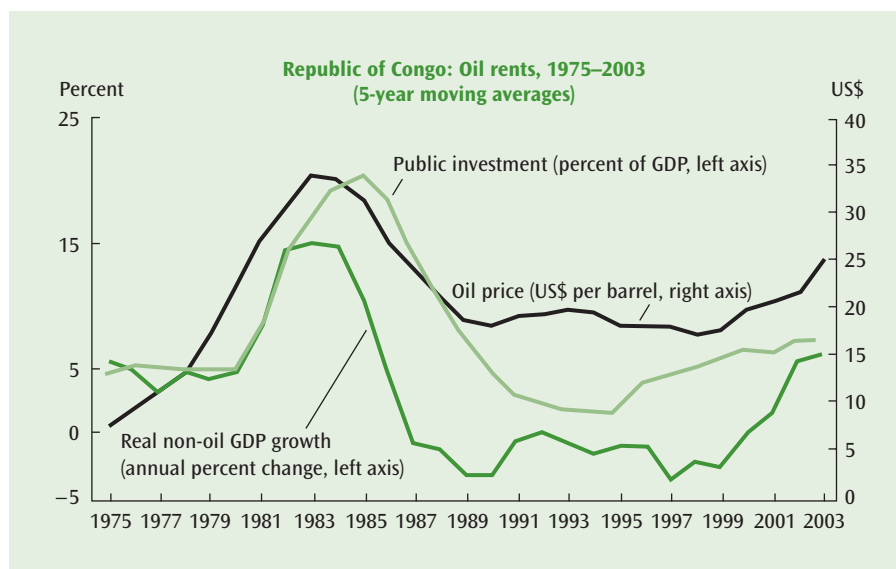
Growth Accelerations

To achieve the MDGs, the central challenge facing Africa is generating at least 10 years of sharply accelerated growth. Such growth accelerations, while not uncommon, have proven somewhat more elusive in Sub-Saharan Africa (table 2.4).¹⁷ Between 1960 and 2003, across developing countries as a whole, the probability of a growth acceleration starting in a country in any year averaged 3.3 percent, while 37 percent of observed country years occurred during an acceleration episode. But in

BOX 2.4 A gush of oil rents and surge in public investment do not ensure sustained growth

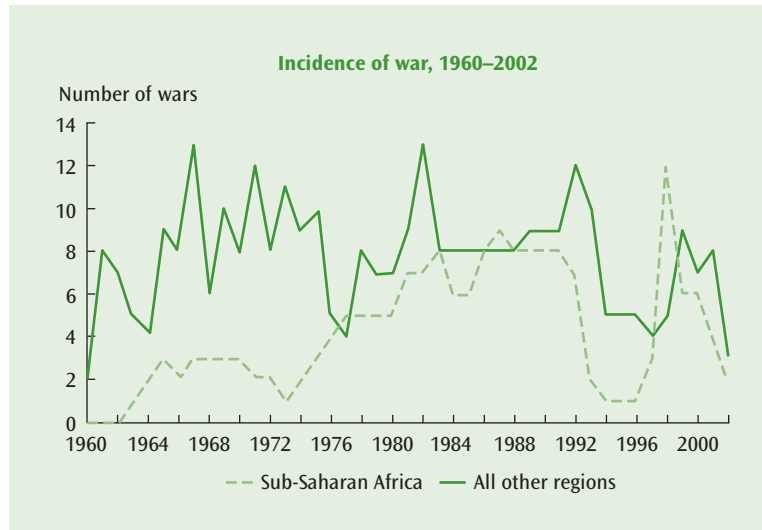
In the 1970s the Republic of Congo began to benefit from a large rise in oil rents as international oil prices surged and national oil production increased. In 1979–86 oil prices averaged more than \$30 a barrel (up from \$14 in 1978 and \$2 in 1970), and by 1986 national production reached 120,000 barrels a day (up from 65,000 in 1980). Suddenly the Congo was much richer and the state treasury—as the main local beneficiary of the enclave oil sector—experienced a surge in revenues. The ensuing increase in government spending helped to generate a temporary growth acceleration (see figure below, and Hausmann and others 2004).

The failure to sustain the growth spurt of the early 1980s was apparently not due to appropriation of the rents for consumption. The Congo significantly boosted public investment—indeed, between 1980 and 1986 (again taking 1979 as the base year) the increase in public capital spending was equivalent to 93 percent of the additional government oil revenues. The impact on social indicators was positive, including a surge in electricity consumption and school enrollments. Ultimately, however, weak policies and institutions (including a highly overvalued real exchange rate and low governance ratings) did not sustain the growth spurt. Real per capita income, which had risen to almost \$1,000 in the mid-1980s, fell to less than \$900 by 2000 (measured in purchasing power parity terms and constant dollars), and the improvements in social indicators proved temporary. Significantly, aid flows increased throughout the oil boom until reaching a peak, at just over \$70 per capita, in the mid-1990s.



Source: IMF (2004).

Note: The use of five-year moving averages is intended to capture the effects of faster financial than physical execution and of the usual lags in bringing projects fully online.

FIGURE 2.6 Sub-Saharan Africa has suffered from many conflicts

Source: World Bank Staff estimates.

BOX 2.5 Political commitment is central to breaking the conflict cycle

Conflict tends to have multiple causes. Typically, an incipient rebel group gets a charismatic leader, the government mishandles counter-insurgency, and a neighboring government sees an opportunity for mischief. But susceptibility to such events is strongly affected by economic circumstances—namely, low income, low growth, dependence on natural resource exports, and vulnerability to adverse shocks. A legacy of previous conflict also increases the probability of conflict, possibly because the only organizations that flourish are those that profit from violence. The role of aid and economic policy is limited to their impact on the growth rate. If Côte d'Ivoire conforms to the global pattern, its prospects are for prolonged and intermittent violent conflict.

Postconflict experience is highly diverse. Some economies recover rapidly, while others continue to decline. Recent analysis finds that choices of policy, institutions, and governance are radically more important for growth during the postconflict decade than at other times: The same improvement (as measured by country policy and institutional assessments) generates much more growth during the postconflict decade. Aid also appears effective in raising growth during the postconflict decade. But the peak effect of aid occurs in the middle of the decade. In the first few years, although needs are great, capacity to absorb project aid is probably rather limited. Hence an early priority is to rebuild the institutions that manage the spending process.

Because the risk of repeat conflict is high, policy needs to be directed to managing it. Postconflict governments typically maintain high military spending—almost at conflict levels—resulting in very small peace dividends. This can be a major policy error because high military spending in postconflict situations can increase the risk of further conflict. Two good models are Mozambique, where the government radically cut military spending, and Sierra Leone, where peace has been guaranteed not by domestic military spending but by robust external peacekeeping. In addition, strong political commitment to economic development and social inclusion is fundamental.

Sources: Collier and Hoeffler 2002b, 2004; Miguel, Satyanath, and Sergenti 2004.

TABLE 2.4 Growth accelerations have been much less common in Sub-Saharan Africa (percent)

Period	Probability of growth episode starting			Proportion of country years occurring in a growth episode		
	Sub-Saharan Africa	Europe and Central Asia	Other	Sub-Saharan Africa	Europe and Central Asia	Other
1960s	5.5	6.7	8.1	18.8	42.1	42.6
1970s	1.8	0.0	2.7	25.7	14.3	50.2
1980s	0.9	2.7	2.5	11.8	13.4	30.5
1990s	3.3	8.2	3.2	20.2	30.2	32.2
2000–03	28.4	60.2	9.7
All periods	2.4	2.5	3.3	20.0	32.5	36.7

Sources: Penn World Tables database; IMF, *World Economic Outlook*; and IMF staff calculations.

Sub-Saharan Africa the annual probability of such an episode starting was just 2.4 percent, and only 20 percent of country years occurred during such an episode.¹⁸

Not only has it been more difficult to initiate sustained growth in Sub-Saharan Africa, but safeguarding those advances has also been more problematic. Growth acceleration episodes in Sub-Saharan Africa have been more likely to be followed by a period of negative per capita growth: of the 23 accelerations that ended before 1998, only 7 were followed by a period of positive growth.¹⁹ This observation is in sharp contrast to the post-acceleration experience in other regions—such as Latin American and the Caribbean, where 20 of 33 acceleration periods were followed by positive per capita growth.

On a more positive note, in the midst of the general slump of the 1990s, when the average per capita growth rate was negative for the region as a whole, some successes began to emerge in Sub-Saharan Africa. Over the past decade or so Africa saw a faster increase in the frequency of growth episodes, and in the proportion of country years spent in such episodes, than did other regions (with the exception of Europe and Central Asia). Average growth performance during these recent African episodes was similar to that of other regions. In terms of episodes ending in the 1990s or ongoing at the end of 2003, the average annual per capita growth rate was

about 5 percent in Sub-Saharan Africa (figure 2.7).

The experience on the duration of growth accelerations raises a note of caution about episodes under way in Sub-Saharan Africa. Historically, 75 percent (44 percent) of episodes in low-income (middle-income) Sub-Saharan countries end before their 10th anniversary. At the end of 2003 the average length of the episodes under way was 8.5 years for low-income countries and close to 20 years for middle-income countries.

Initial analyses of the determinants of growth accelerations have found that these episodes are not easily amenable to explanation or prediction.²⁰ Still, it is possible to identify some policy and institutional measures that are significant correlates with their inception (box 2.6). The analyses suggest that lower inflation, higher fiscal expenditures on investment (within a given spending envelope), higher private investment, and better governance are associated with the beginning of growth accelerations, particularly those that last longer.

Macroeconomic Policy: Stability, Sustainability, and Space

Recent progress toward macroeconomic stability across Sub-Saharan Africa has begun to remove obstacles to vigorous economic growth, and growth has picked up in some

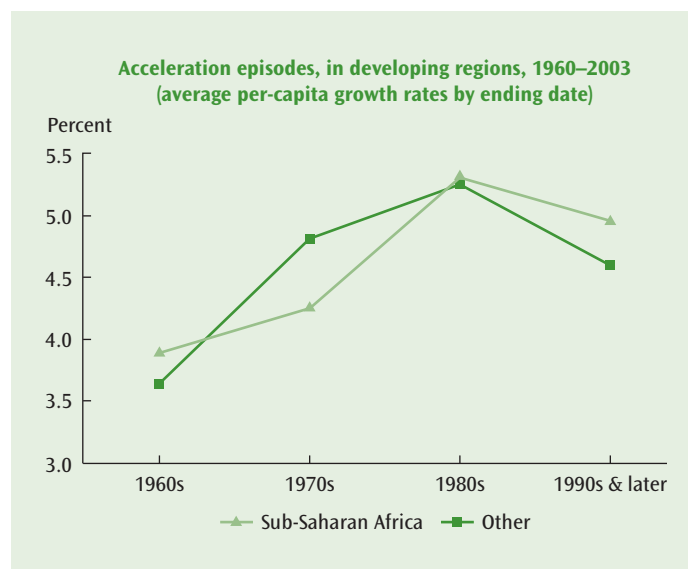
countries. On the whole, however, the region continues to suffer from low growth. Key macroeconomic issues include the sustainability of the fiscal stance and the availability of fiscal space for additional investments in such crucial areas as physical infrastructure and human capital.

Underlying this discussion is the notion that a stable policy framework is a crucial determinant of an enabling macroeconomic environment. Moreover, the relationship between the policy framework, macroeconomic stability, and economic growth is intermediated by the institutional setting.²¹ Ultimately, higher growth is the result of profitable investment opportunities, whose feasibility depends not just on macroeconomic predictability but also on the state of the microeconomy and the (enabling) role of institutions. Macroeconomic stability is thus a necessary but insufficient condition for sustained growth.

Over the medium term it is crucial that fiscal policy be perceived as sustainable. The fiscal stance is sustainable when it is unlikely that wrenching policy adjustments will be required to maintain stability and avoid crisis. Such a policy configuration increases the predictability of the macroeconomic environment and ensures the long-term viability of a noninflationary growth path. Policy stability contributes to macroeconomic stability by removing the effects of destabilizing policies and enabling a stabilizing response to exogenous shocks.

In low-income countries fiscal sustainability has two crucial dimensions: reliance on external concessional financing; and the need to limit recourse to domestic financing. The high degree of concessionality of external finance implies that, as long as the productivity of public investment is reasonable and the country does not experience large adverse shocks, further external finance should not threaten sustainability.²² With underdeveloped financial sectors, most governments in Sub-Saharan Africa do not have the option of raising substantial sums from domestic capital markets, and the growth of domestic credit (and therefore money supply and

FIGURE 2.7 Annual growth rates during accelerations are improving in Sub-Saharan Africa



Source: IMF staff calculations.

prices) tends to be closely linked to government financing requirements.²³

Additionally, the effect of government spending on growth depends on the macroeconomic context and the composition of expenditures. If macroeconomic stability is lacking, even productive government spending can, on net, have an adverse effect on growth, due to negative macroeconomic consequences. On the other hand, a structure of spending that is financed in a sustainable manner and that favors growth-sensitive sectors can be expected to increase factor productivity and crowd in private investment, including by reducing private sector costs.

Targeting fiscal sustainability while paying attention to the structure and quality of fiscal spending is fully consistent with the goal of promoting productive public investment. For Sub-Saharan Africa, further progress toward fiscal sustainability will be necessary to secure recent gains, and the current structure of spending could be made more commensurate with the growth imperative. Institutionalizing improvements in macroeconomic policy may be a quick way to change perceptions.

BOX 2.6 Better macroeconomic policies and stronger institutions are associated with longer growth accelerations

While statistical models of growth accelerations have modest explanatory power, there is some evidence that improvements in key policies and institutions tend to accompany the onset of such accelerations—particularly in the case of longer episodes. Comparing the behavior of key policy and institutional variables at the onset of growth accelerations with the preceding five-year period indicates that rapid increases in growth tend to be accompanied by a lower level of inflation, a less distorted exchange rate, and an improved perception of law and order. On the other hand, there is no evidence of major changes in investment, exports, terms of trade, foreign aid, or savings.

Over the lifetime of growth accelerations, there is improvement in a broader set of indicators. While this result would generally be expected for macroeconomic variables, including private investment and the fiscal balance, it is perhaps surprising in the case of institutions, which are generally thought to be relatively stable. During a typical 10–12 year acceleration, indicators of political regime, bureaucratic quality, and law and order improve by a statistically significant amount, raising the possibility of a virtuous circle whereby higher growth facilitates institutional reform.

Just as critical as spurring growth accelerations is sustaining them. The improvements observed during accelerations are consistent with the idea that ongoing reforms are necessary to sustain such accelerations, but it is also possible that faster growth enables policy improvements. Comparing the degree of upfront improvements in indicators across longer episodes (those lasting at least nine years) and shorter episodes (those lasting less than eight years) sheds some light on what tends to make accelerations durable.

Upfront improvements in macroeconomic indicators are more generalized for longer than shorter episodes (see table). First, the improvements in inflation and the exchange rate that tend to accompany the onset of accelerations are stronger for longer accelerations. Second, longer episodes

tend to be more private sector-led, with lower government consumption and higher private investment. Third, there is an upfront improvement in the perception of corruption in episodes that turn out to be longer. These results are generally robust across different groups of countries, including Sub-Saharan and low-income countries, and similar conclusions emerge when the assessment is made three years into episodes of growth accelerations.

These results offer hope that recent improvements in these indicators in a number of Sub-Saharan countries may mean that ongoing African accelerations will prove more sustained than in the past.

Changes in values of key indicators at the onset of long relative to short acceleration episodes (percent except where noted)

Inflation rate	–10.6
Government consumption/GDP	–4.1
Noninterest spending/GDP	–4.2
Black market premium	–39.2
Law and order (index)	0.1
Corruption (index)	0.6
Private investment/GDP	2.5

Note: Numbers in bold indicate statistical significance at the 10 percent level. Corruption and law and order are measured on a scale of 1–6, where a higher score indicates less corruption and stronger law and order.

Source: IMF staff.

Note: For purposes of this analysis, a growth acceleration is deemed to last at least five years (the average duration exceeds eight years) and to be defined by an increase in annual average per capita GDP growth of at least 2 percent (accelerating growth) and annual average per capita growth of at least 3.5 percent (rapid growth). Accelerations are deemed to end when annual per capita GDP growth dips below an average of 2 percent for the subsequent five-year period, or below 3 percent in the year immediately following the period of acceleration. This is an extension of the definition proposed by Hausmann, Pritchett, and Rodrik (2004).

Recent Developments in Macroeconomic Policy and Stability

Across low-income countries as a whole, macroeconomic policies have improved over the past decade. Inflation has slowed appreciably, and other indicators—such as fiscal and current account deficits—have also improved, though more modestly (table 2.5). Similar patterns have emerged in Sub-Saharan Africa. On this basis, to what extent can stabilization in Sub-Saharan Africa, as the region most in need of a growth payoff, be considered a success?

Macroeconomic stability depends heavily on control of inflation and sound fiscal performance, although some definitions of stability also include criteria on growth rates (as an additional measure of internal macroeconomic balance) and international reserve levels (as a measure of robustness to external shocks).²⁴ The rationale for the inclusion of a fiscal criterion derives from the close link between the fiscal stance and inflation, particularly in an environment where fiscal policy holds sway over monetary policy or where the scope for noninflationary domestic financing is limited.

Given Sub-Saharan Africa's heavy reliance on concessional external financing, it seems appropriate to assess the fiscal contribution to stabilization by monitoring domestic financing of the budget deficit, instead of the deficit itself. Not only does external financing have less of an impact on inflation than does domestic financing, but most of this borrowing tends to come with a sizable grant element, further diluting the applicability of the fiscal balance measure. In this context a forthcoming International Monetary Fund (IMF) study, in defining successful stabilization efforts in developing countries, measures fiscal sustainability in terms of limited recourse to domestic financing, proxied by a target of less than 1 percent of GDP.²⁵

With the recent progress toward price stability, most countries in Sub-Saharan Africa

have reasonably low inflation. During 2000–3 the median rate of inflation was 5 percent, and only a half-dozen countries (Angola, Eritrea, Liberia, Nigeria, Zambia, Zimbabwe) recorded annual price increases persistently above 10 percent. But progress on the fiscal front has been less consistent.²⁶ Although domestic financing in Sub-Saharan Africa averaged close to 1 percent of GDP during 2001–3, about one-third of countries in the region exceeded this level. Of those, 12 recorded domestic financing ratios persistently higher than 3 percent of GDP. In these countries further progress on fiscal consolidation would appear particularly prudent in order to safeguard the recent improvements on the inflation front.²⁷

This general assessment disguises considerable variation across the region. As a group, middle-income Sub-Saharan countries have registered substantial progress on macroeconomic stability since the early 1990s.²⁸ These countries have averaged annual per capita growth rates of nearly 4.5 percent, and their fiscal positions appear sound. At the end of 2003 their recourse to domestic budget financing stood at close to 1 percent of GDP, while their stock of international reserves reached five months of imports—levels that would allow flexibility in the event of unanticipated fiscal challenges.

For low-income Sub-Saharan countries, tangible progress toward stabilization started to materialize only in the second half of the 1990s. But by 2000–3 the picture had brightened considerably. Within this group, natural resource-dependent economies have benefited most from recent movements in international prices. As a result their fiscal position has strengthened, with the primary budget in balance, supplemented by external grants of almost 4 percent of GDP. Of potential concern, however, these countries remain exposed to international price corrections—and domestically, recent appreciations in real

TABLE 2.5 Macroeconomic indicators have generally improved in low-income countries
(annual average except where indicated)

Indicator/region	1984–8	1989–93	1994–8	1999–03	2004 (estimate)	2005–9 (projected)
Inflation (percent, median) ^a						
East Asia and the Pacific	7.1	9.5	8.7	6.1	5.8	3.6
Europe and Central Asia	1.2	417.7	233.8	10.2	5.6	4.2
Latin America and the Caribbean	4.4	12.6	6.7	3.3	3.9	3.1
Middle East and North Africa	14.2	23.1	21.0	6.3	8.6	7.1
South Asia	7.7	10.5	8.4	3.7	4.6	4.1
Sub-Saharan Africa	9.9	10.6	12.7	5.6	6.5	3.6
All low-income countries	6.8	10.8	11.9	4.7	5.0	3.8
Current account balance (percentage of GDP) ^b						
East Asia and the Pacific	–1.9	–4.4	–1.5	–1.3	–1.1	–3.1
Europe and Central Asia	–1.0	–6.4	–11.7	–7.1	–7.7	–2.5
Latin America and the Caribbean	–10.8	–14.3	–14.1	–12.1	–11.7	–11.3
Middle East and North Africa	–6.5	–5.4	–1.4	0.3	–3.6	–9.8
South Asia	–7.2	–5.7	–2.4	–1.3	–2.0	–2.3
Sub-Saharan Africa	–7.2	–8.5	–9.1	–8.8	–7.7	–6.8
All low-income countries	–6.1	–8.0	–8.0	–6.9	–6.5	–5.9
External debt (percentage of GDP)						
East Asia and the Pacific	63.1	69.4	58.5	60.1	56.5	52.3
Europe and Central Asia	0.0	14.2	49.8	63.8	49.8	43.6
Latin America and the Caribbean	105.8	178.2	92.5	68.0	60.6	58.8
Middle East and North Africa	53.4	57.1	68.6	59.9	53.3	48.4
South Asia	45.5	50.8	45.1	45.6	46.0	40.1
Sub-Saharan Africa	85.9	108.1	136.7	120.5	97.4	84.0
All low-income countries	70.6	93.5	99.2	89.6	75.1	66.2
Fiscal balance (percentage of GDP) ^b						
East Asia and the Pacific	–8.9	–5.7	–4.0	–5.0	–3.8	–3.5
Europe and Central Asia	–1.2	–11.1	–7.7	–3.6	–2.0	–0.2
Latin America and the Caribbean	–7.7	–5.1	–2.4	–5.0	–3.9	–2.8
Middle East and North Africa	–16.7	–11.2	–6.0	–0.5	–1.8	–8.2
South Asia	–5.5	–5.0	–4.8	–5.9	–4.9	–4.7
Sub-Saharan Africa	–6.2	–6.9	–5.5	–5.4	–3.2	–1.3
All low-income countries	–6.5	–6.9	–5.1	–5.0	–3.3	–2.2
Memorandum item: real per capita						
GDP growth (percent)						
All low-income countries	1.3	–1.3	1.5	1.5	2.8	3.3

Source: IMF, World Economic Outlook database.

Note: Averages are calculated as unweighted means of country values.

a. Calculated from annual medians, then averaged over five-year periods.

b. Includes grants.

exchange rates may weaken the competitive position of nonresource sectors, on which most people depend. In addition, fiscal policy in these countries has tended to be procyclical, partly a reflection of some unique challenges

imposed on public policy by the nature of oil operations (box 2.7).

For most of these countries the challenge is to strengthen the fiscal outlook (and stabilize prices) not just for an interim phase, but for a

BOX 2.7 Challenges for fiscal policy in oil-producing Sub-Saharan countries

Like oil-producing countries elsewhere, those in Sub-Saharan Africa face some sharp challenges. At a technical level, the main challenges stem from the high volatility and unpredictability of oil prices and the nonrenewable nature of oil reserves. At an institutional level, the nature of oil operations raises the social benefit of good governance.

Uncertainty about oil prices translates into uncertainty about fiscal revenues. As a result the fiscal balance tends to be volatile and unrelated to developments in domestic demand. One of the main concerns of policymakers should be insulating the local economy from this volatility. In this context two standard policy prescriptions are that fiscal policy should be guided by the non-oil primary balance, as a fiscal target, and by caution, as a motive for building up financial reserves. Contrary to these prescriptions, oil economies in Sub-Saharan Africa have tended to carry out fiscal policies that are procyclical relative to oil price movements, leading to variability in the real exchange rate, which tends to be damaging to the non-oil sector and capital formation, and to increased fiscal costs, including through a negative impact on spending levels and quality induced by boom-bust cycles. It is also desirable for such countries to build up financial reserves against unanticipated falls in revenue, but such prudence in fiscal policies has not always emerged. One example of good practice is Botswana, which in 2001–2 absorbed a confluence of shocks by relying on income from accumulated financial assets.

The second challenge stems from the nonrenewable nature of oil revenues and the attendant rise in the importance of long-run fiscal sustainability, mainly due to concerns for intergenerational equity. In countries with significant short-term development needs and insufficient physical and human capital, intergenerational equity could conceivably be secured through sufficient accumulation of financial and nonfinancial assets. In this context it is essential that projects be compatible with broader development strategies and projected returns secured by strong oversight. But as discussed in the case of the Congo (see box 2.4), returns have not always matched expectations.

At an institutional level, strong governance is of primary importance in the context of an enclave oil sector, which benefits a country mainly through its tax payments, and the nature of oil revenues, which tend to be both high and easily appropriated. With the government being the channel of most of the possible benefits of an enclave oil sector, judicious use of government revenues is even more critical than usual. Otherwise the rest of the economy only sees its competitiveness eroded (the Dutch disease effect).

In an environment with weak oversight institutions, the size of oil revenues may mean that the public sector is asked to manage more resources than it can prudently administer and that the governing elite acquires substantial financial independence. Oil-producing Sub-Saharan countries tend to underperform on key dimensions of economic governance. Yet given the extreme need to ensure judicious administration of public resources, these are precisely the countries where good governance has the highest social benefit. With their income derived mostly from the oil sector, including possibly in illicit ways, the governing elite are less motivated to strengthen oversight institutions, and the overall investment climate suffers.

The nature of oil contracts tends to further obfuscate public sector management and hamper revenue transparency. The typical results are fiscal policies that are beholden not to the population, but to entrenched elites. Under the typical oil contract in Sub-Saharan Africa, the bulk of the fiscal regime is subject to confidentiality clauses and unknown to the public. In such circumstances the system draws resources, including human capital, into activities geared to appropriating rents rather than encouraging more directly productive activities. Elites tend to favor excessive and imprudent investments—especially large projects, which are particularly prone to graft, and other inefficient means of rent distribution, such as sustained protection for favored firms.

In light of the resulting difficulties of implementing prudent fiscal policy and promoting sound economic governance in oil-producing countries, the creation of oil savings funds is often proposed as a solution. It is crucial to integrate such funds into the overall design of fiscal policy and the budget process. They have tended to work well in environments with strong institutions, such as Canada (Alberta), Norway, and the United States (Alaska). But savings funds have tended not to work where underlying institutions were weak and political commitment was lacking, as with Mexico's oil stabilization fund and the Venezuelan Investment Fund.

Source: IMF staff.

sustained period and in a credible manner. For a significant impact on growth, “gains in macroeconomic stability need to be viewed by the private sector as indicative of a *permanent* change in the macroeconomic policy regime.”²⁹

Fiscal Institutions: Key to Fiscal Sustainability and Macroeconomic Predictability

At a fundamental level, strong fiscal institutions enhance fiscal discipline and provide clear evidence on the direction of policy. A growing literature has indicated that institutional weaknesses, such as budget institutions that allow narrow interests to prevail, play an important role in influencing fiscal outcomes. Some developing countries lack institutions that can promote sound fiscal policies, such as:

- Transparency, including wide dissemination of key economic data and controls on public enterprise budgets.

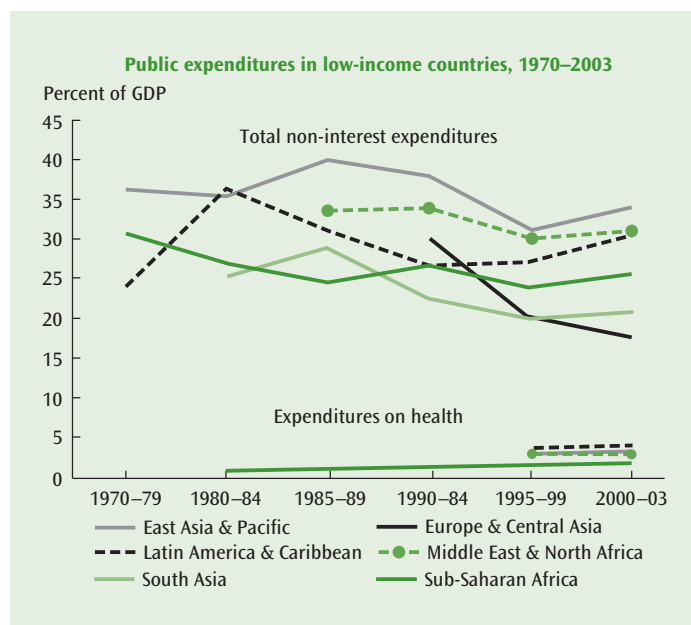
- Judicial systems that control tax evasion.
- Spending constraints that mitigate tendencies toward inefficient and procyclical spending policies.

The structure of public spending in some Sub-Saharan countries could be made more commensurate with the growth imperative. Fiscal adjustment and sustainability should be viewed not just in terms of quantity but also quality. To the extent that basic investments in physical and human capital raise growth, it is crucial to orient public spending toward productive projects in these areas.

Recent increases in social sector allocations in low-income countries implementing poverty reduction strategies (PRSs) have begun to make a difference, but there is scope for further improvement. In 2000–3 increases in the spending envelope (noninterest spending as a percentage of GDP) have not resulted in additional allocations to public investment. Moreover, given the consensus on the need to rapidly raise the level of human capital across the region, further progress on raising the share of noninterest spending allocated to education and health would appear necessary. This is particularly the case for health spending, for which Sub-Saharan Africa falls at the bottom among developing regions (figure 2.8).³⁰

Looking ahead, it will be essential that Sub-Saharan countries underpin attempts to strengthen their fiscal outlook with enhanced transparency and stronger fiscal institutions. Budget transparency has been associated with enhanced fiscal discipline, particularly in the aftermath of the East Asian crisis of the late 1990s, and enhanced government accountability. The more transparent government operations are, the easier it is to identify fiscal policy weaknesses and address them. Fiscal transparency improves the business environment because investors (domestic and foreign) gain more confidence in government policies, and transparency can improve sovereign credit rating—a tangible benefit for cash-strapped governments. Consequently, the IMF published the *Fiscal Transparency Code* in 1999 and the *Manual on Fiscal*

FIGURE 2.8 There is scope for allocating more to priority sectors such as health



Sources: IMF, World Economic Outlook database and World Bank, World Development Indicators database.

Transparency in 2001, and a draft *Guide on Resource Revenue Transparency* is available for public comments and will be published in the near future. The earlier publications serve as a framework for the fiscal Report on the Observance of Standards and Codes (ROSC), a voluntary diagnostic tool that assesses the availability and quality of fiscal data. In Sub-Saharan Africa 11 countries have agreed to publish fiscal ROSCs, and the assessments,

while recording some progress and examples of good practice, highlight the general need for better budget formulation and reporting, and broader data coverage (box 2.8).

One Sub-Saharan country that has recently made significant strides toward fiscal transparency is the Republic of Congo, where the publication of fiscal data, audit reports on oil activities, and reports on external verification of government revenues, oil contracts, and data

BOX 2.8 Fiscal transparency has improved in Africa, but much remains to be done

Country-specific fiscal transparency assessments—called fiscal Reports on the Observance of Standards and Codes, or fiscal ROSCs—have been published on the IMF's Web site for more than 70 countries, including a number of countries in Sub-Saharan Africa (Benin, Burkina Faso, Cameroon, Ghana, Malawi, Mali, Mauritania, Mozambique, Rwanda, Tanzania, Uganda). Reports are being prepared for several other Sub-Saharan countries.

The assessments record some progress in improving fiscal transparency in a number of areas, including the quality of budget formulation and investment in fiscal reporting systems. South Africa, while it has not published a fiscal ROSC, provides examples of good transparency practices, including clear policy statements and publication of a “budget in brief”—a summary of the government budget written for the layman. But fiscal ROSCs have also found that much still remains to be done in Africa. For example, in many Sub-Saharan countries central government budget data remain weak and unreliable, and there is insufficient reporting on local government fiscal operations. Fiscal risks related to off-budget activities (such as quasi-fiscal activities related to state-owned enterprises or banks, contingent liabilities, tax expenditures) are often not transparent. External audit is generally weak, impairing the ability of parliaments and the general public to monitor government operations and hold the executive branch accountable for its actions. There appears to be a strong need to maintain continuing assessment of fiscal transparency in Sub-Saharan Africa and to encourage publication and dissemination of good practices that are in place.

The need for better fiscal transparency in resource-rich countries has recently gained some prominence. Several Sub-Saharan countries, including Ghana and Nigeria, have begun to participate in the Extractive Industries Transparency Initiative. This initiative emphasizes the need for oil and other extractive industry companies to publish what they pay to governments and to reconcile these payments with what government reports show that they have received from companies. The IMF has prepared a draft *Guide on Resource Revenue Transparency*, which supplements its *Manual on Fiscal Transparency* and can be used to assess fiscal transparency in resource-rich countries. The draft guide has been released for public comments (<http://www.imf.org/external/np/sec/pr/2004/pr04274.htm>). A number of pilot country assessments are being undertaken in resource-rich countries—including Equatorial Guinea, which recently hosted a seminar for parliamentarians from the six countries of the Economic and Monetary Community of Central African States (CEMAC) that focused on fiscal transparency and accountability (see *IMF Survey*, 7 February 2005).

Note: The IMF has promoted fiscal transparency over the past several years as part of its Standards and Codes initiative. Its Fiscal Transparency Code and *Manual on Fiscal Transparency* are available at <http://www.imf.org/>.

Source: IMF staff.

has been influential in convincing development partners that a significant change in the policy regime is under way.³¹ Nevertheless, as discussed below, broader gains in governance are needed for Sub-Saharan Africa to reach the level attained by other developing regions.

More broadly, stronger fiscal institutions can improve fiscal management by clarifying lines of responsibility and constraining the political bargaining that typically affects fiscal outcomes. One approach has been to create autonomous revenue agencies and grant central banks independence in the pursuit of price stability. Another has been to strengthen rules governing budget procedures and reporting, often in the context of medium-term expenditure frameworks (MTEF). Neither approach has been widely embraced in Sub-Saharan Africa. Institutional independence is more likely to be effective in a climate with multiple checks and balances, and an MTEF is only effective when fully integrated with the budget process and related documents—which has only happened in five Sub-Saharan countries.³² Yet another approach is to adopt a fiscal responsibility act, under which broad discussion of the policies underlying budget documents precedes formal presentation of the budget. The debate takes place both within and outside parliament, improving transparency and binding government over the medium term—as in Brazil, which adopted a fiscal responsibility law in 2000.³³

Fiscal Space: Safeguarding Development Spending

The identification of significant infrastructure gaps, particularly in Latin America, has led to calls for the creation of fiscal space through a revision in accounting rules and change in the approach to fiscal analysis. It has been suggested that data on fiscal expenditures should not cover the operations of public enterprises, and that fiscal programming should target the current, instead of overall, fiscal deficit. These arguments have also been marshaled as a way to substantially increase government spending on the MDGs.

Ultimately, a change in accounting rules cannot make the resource envelope larger or ensure that additional spending is justified. For Sub-Saharan Africa the proposed change in fiscal data coverage would not have much of an impact, given that standard practice across the region already limits coverage to general government (and only records direct transfers to public enterprises as fiscal expenditures). Moreover, targeting the current deficit (as a way of treating investment spending differently from recurrent spending) would not obviate the need to assess the sustainability of debt loads, the impact of higher domestic financing on inflation and private investment, and the productivity of expenditure.³⁴

Effectively creating fiscal space would require, first, generating additional resources and, second, ensuring that projects are appropriately selected and implemented. Domestic sources of additional resources include mobilization of additional fiscal revenue and domestic borrowing. Scope for the latter is typically limited, however, in part because financial markets in Sub-Saharan Africa are thin and in part because of a need to preserve domestic savings for private investment. External sources include a sustained and predictable flow of external grants (and, to a lesser extent, other concessional borrowing). Ensuring the overall adequacy and quality of development spending may entail reprioritizing expenditure toward more productive sectors and projects (as discussed earlier), and lifting limits on absorption capacity, including by improving expenditure monitoring systems.

In Sub-Saharan Africa the bulk of the additional financing required to achieve the MDGs will have to come from sources other than additional taxation. Certainly, tax revenue ratios in low-income Sub-Saharan countries are on the low side. But raising revenue ratios will require improvements in tax administration and resolution of important issues of tax design, including greater reliance on indirect taxation schemes such as the value added tax (VAT).³⁵ The associated political and administrative challenges are not easily overcome in a short period.³⁶

External grants unambiguously enhance fiscal space—in contrast to borrowing, where such space is constrained by debt sustainability considerations, even when loans are concessional. Still, a sustained, predictable flow of external grants is needed to secure a sustained scaling up of expenditures. Historically, aid flows have been more volatile and less predictable than other sources of revenue.³⁷ These tendencies have been more pronounced for countries least capable of absorbing external shocks: those with a higher proportion of aid-financed budgets and those with fewer domestic financial instruments to smooth the fiscal impact. These effects undermine some of the benefits of foreign assistance.

In Sub-Saharan Africa recent drops in public investment underscore the importance of improving capacity to implement productive projects. Over the past two decades the share of public investment has fallen by about 3 percentage points of GDP across the region. Although part of the drop has been offset by rising private investment, budget execution in low-income Sub-Saharan countries regularly results in lower than programmed capital spending and overruns on current spending. The shortfalls in capital spending cannot be attributed entirely to lower than expected foreign financing—underscoring the importance of improving project selection and implementation.

Better public expenditure management is critical in addressing concerns about the relationship between additional spending, public service delivery, and improved outcomes. Attempts have been made to address public expenditure management in the context of efforts to increase pro-poor spending under the aegis of the enhanced HIPC Initiative (box 2.9). The reported increase in poverty-reducing spending will have to be supplemented by improvements in efficiency and targeting to raise social outcomes. For this, countries must also develop the means to assess the effectiveness and social impact of poverty-reducing spending.

More generally, identifying and addressing absorptive capacity constraints requires for-

mulating country-specific strategies. At the macroeconomic level, aid may distort domestic markets by raising the price of domestic goods and services, and impair economic performance by threatening fiscal sustainability (particularly with volatile and unpredictable aid flows). Managing these policy challenges is facilitated by the use of a medium-term fiscal framework and flexibility in adjusting expenditure and revenues, and possibly by the absorption of shortfalls in aid flows with the use of international reserves or nonmonetary financing instruments. For some sectors, such as health and education, human and physical infrastructure constraints may also be relevant. Addressing these concerns is likely to require more resources and time.

In sum, sustained effort is necessary to ensure that recent progress toward a stable macroeconomic environment marks a permanent shift in the policy regime. In the short term, with high fiscal deficits and limited ability to raise revenues, most increases in domestic contributions to the region's development needs will come from higher economic growth and a shift in spending toward high-quality projects in growth-sensitive sectors.

Finally, macroeconomic stability cannot bear the entire burden of boosting economic growth. As the past two decades have shown, Sub-Saharan Africa's institutional environment has not always ensured that policy gains translate into permanent improvements. Fiscal institutions should ensure transparency, effective expenditure monitoring, and sustainability. Institutionalizing nascent improvements in macroeconomic policy may be a quick way to change perceptions.

Enabling Climate for Private Sector Activity

The earlier analysis of growth accelerations indicates that private investment can play a significant role in supporting sustained economic growth. In slow-growing economies in Sub-Saharan Africa and elsewhere, investment is typically low.³⁸ The rate of return on investment also tends to be low, due to low

BOX 2.9 Strengthening expenditure monitoring under the enhanced HIPC Initiative

The IMF and World Bank have been working closely with countries benefiting from the enhanced HIPC initiative to strengthen the link between HIPC assistance and poverty reduction. Recognizing that public expenditure management plays a key role in poverty reduction, action plans for expenditure management were agreed with the authorities of each HIPC—taking into account the technical assistance available to them from their development partners—and two assessments of those plans have been completed. (More generally, a key feature of the IMF's Poverty Reduction and Growth Facility, the Bank's Poverty Reduction Strategy Credits, and the PRS approach is that the budgets of low-income countries should become more pro-poor, which makes tracking poverty-reducing spending relevant to all PRS countries.) Under the 2001 assessment, progress was tracked using 15 indicators: 7 related to budget preparation and 4 each to execution and reporting. For the 2004 assessment a new indicator was added, on procurement.

After the first assessment confirmed the weak state of public expenditure management systems, HIPCs began strengthening expenditure management and monitoring. By 2004 most were able to report poverty-reducing spending as defined in their PRSs, and the average number of benchmarks met increased from 6.0 to 6.5. (The second assessment covered 25 HIPCs—22 in Sub-Saharan Africa and 3 in Latin America; see table.) On average, pro-poor spending has grown by about 2 percent of GDP a year. But to reduce poverty, higher spending must be accompanied by increased efficiency and better targeting to improve social outcomes. Revised action plans are being incorporated into IMF-supported programs and Bank adjustment operations—and to increase ownership, should also be incorporated into PRSs.

Many HIPCs need to substantially upgrade public expenditure management

Level of upgrading required	2004		
	Substantial	Some	Little
2001			
Substantial (7 or fewer benchmarks met)	Bolivia (5, 4) Cameroon (4, 7) Ethiopia (6, 7) The Gambia (5, 3) Ghana (1, 7) Guinea (5, 5) Madagascar (7, 4) Malawi (7, 5)	Mozambique (5, 4) Niger (3, 5) São Tomé and Príncipe (4, 4) Senegal (4, 7) Zambia (3, 3)	
Some (8–10 benchmarks met)	Chad (8, 7) Honduras (8, 7)	Benin (8, 8) Burkina Faso (8, 9) Guyana (8, 10) Rwanda (8, 8) Uganda (9, 8)	Mali (8, 11) Tanzania (8, 11)
Little (11 or more benchmarks met)			
Not assessed in 2001	Democratic Republic of Congo (4) Guinea-Bissau (0) Sierra Leone (7)		

Note: Numbers in parentheses are the number of benchmarks met in 2001 and 2004, in that order.

Source: IMF (2003); and IMF and World Bank staff.

productivity and high costs of doing business.³⁹ Faster growth requires a business climate that enables the private sector to take up profitable investment opportunities, raising both the level and productivity of investment.

In many developing countries excessive regulation and other institutional constraints impose a heavy burden on entrepreneurial activity. A number of countries are implementing regulatory reforms, but recent improvements need to be deepened and underpinned by stronger institutions—particularly those related to property rights and the rule of law. Alongside regulatory and institutional reform, access to finance and availability of key infrastructure need to be improved. Limited access to credit and poor infrastructure undermine private activity in many countries, limiting growth in industry and agriculture alike. Among regions, Sub-Saharan Africa has the greatest need to improve these determinants of the business environment.

Assessing the Business Environment

Recent enterprise surveys and business regulation assessments provide the necessary metrics for a careful evaluation of the investment climate in developing countries.⁴⁰ The enterprise surveys provide benchmarks of investment climate indicators and firm performance, allowing conclusions to be drawn on constraints facing entrepreneurs. The business regulation assessments provide benchmarks of regulatory and property protection systems, providing policy guidance on areas needing improvement. Across the developing world, entrepreneurs consistently report regulatory impediments, corruption, and lack of access to finance and key infrastructure (such as electricity) as major constraints on their activity.

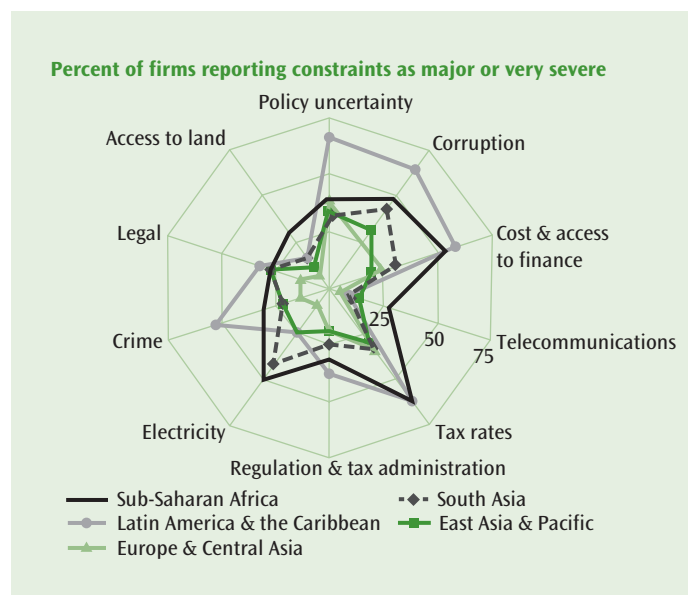
Firms in Sub-Saharan Africa consider high taxes and poor access to finance to be among their most significant constraints (figure 2.9). In countries with small tax bases, firms often bear a disproportionate share of the tax burden, particularly small and medium-size firms. With the informal sector representing

more than 70 percent of nonagricultural employment in the region, many firms do not pay any taxes—or report only a fraction of their sales to the authorities. And many firms, particularly small ones, do not see many benefits from becoming formal. Most firms lack confidence that courts will uphold their property rights, and most have little access to finance due to shallow financial systems and the difficulty of obtaining collateral.

Corruption and policy uncertainty are also significant constraints in Sub-Saharan Africa. In particular, the discretion that many officials enjoy in implementing complex regulations creates opportunities for bribes and uneven application of requirements. More than 95 percent of firms in the region report that corruption or policy uncertainty are a problem, with most firms calling them major or very severe constraints on their ability to operate and expand.

Unreliable electricity supply is reported as a constraint by 52 percent of firms in Sub-Saharan Africa, compared with 42 percent in

FIGURE 2.9 Sub-Saharan firms view taxes, finance, electricity, and corruption as particularly constraining



Source: World Bank Investment Climate Surveys.

Note: The graph does not include every country in each region.

South Asia, 24 percent in East Asia and Latin America, and less than 10 percent in Europe and Central Asia. Moreover, a much larger share of African firms report frequent power outages and serious production losses stemming from such interruptions in production.

There is considerable cross-country variation in the ranking of constraints reported by Sub-Saharan firms. For example, policy uncertainty is reported as a major or severe constraint by 27 percent of firms in Uganda but by 57 percent in Zambia. Similarly, unpredictable interpretation of regulations is a problem cited by 40 percent of firms in Uganda but by 70 percent in Zambia (table 2.6). In Kenya more than 75 percent of firms report paying bribes, averaging more than 5 percent of sales. Losses from power interruptions average 6–7 percent of sales in Ethiopia and Zambia, and 10 percent or more in Eritrea, Kenya, and Senegal.

The above picture, derived from the World Bank's Investment Climate Surveys, is corroborated by its Doing Business indicators. The business environment, as measured by the regulatory burden, is weakest in Sub-Saharan Africa (figure 2.10).⁴¹ Among the 20 countries with the most regulatory obstacles to doing business, 16 are in Sub-Saharan Africa—with Angola, Burkina Faso, Chad, and the Democratic Republic of Congo ranking among the

worst 5 worldwide. Entrepreneurs in these countries face a staggering array of costs, including those related to starting a business, registering property, enforcing contracts, hiring and firing workers, getting credit, closing a business, and protecting investors.

On average, starting a company in Sub-Saharan Africa costs the equivalent of 224 percent of national per capita income, compared with 45 percent in South Asia and only 7 percent in high-income countries. Similarly, a simple, formal property transfer costs 14 percent of the value of the property and takes more than 100 days in Africa, compared with 48 days in East Asia and the Pacific and 36 days in high-income countries.

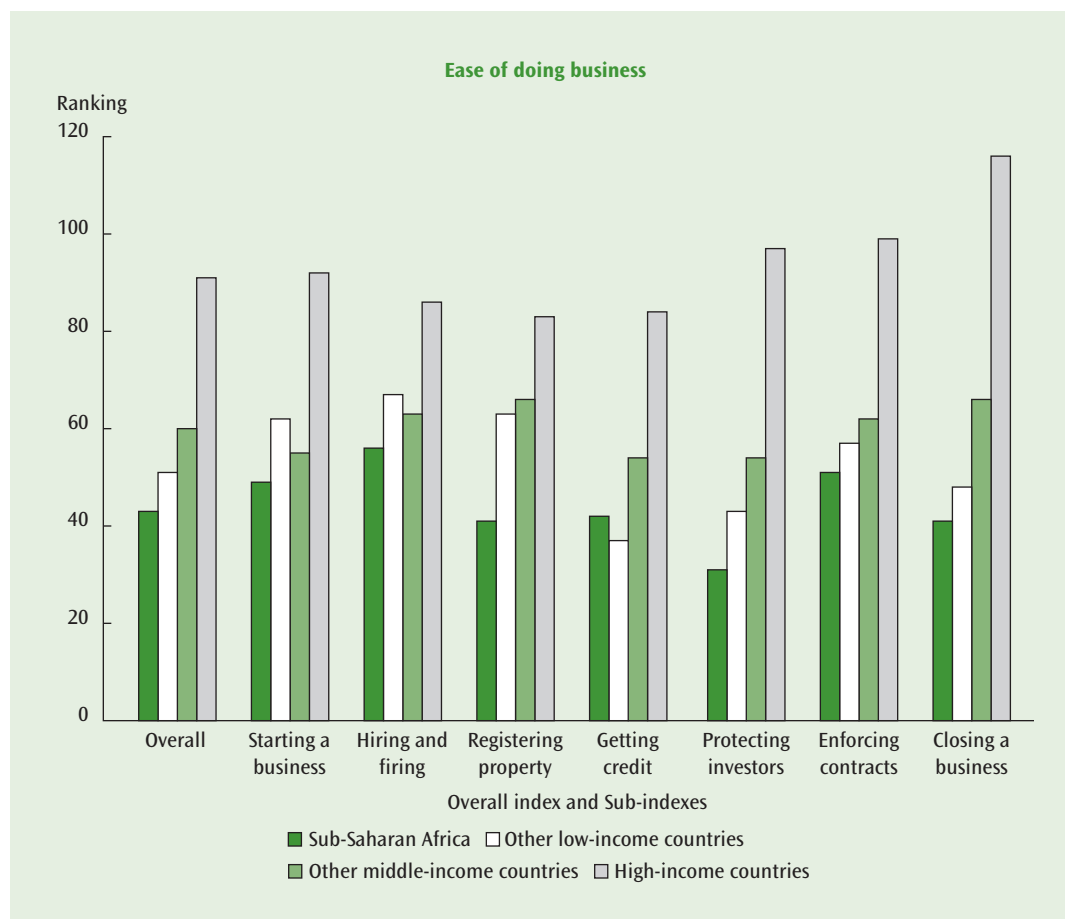
Nigeria has some of the world's most cumbersome regulations for registering property, requiring 21 procedures, 27 percent of the property value in fees, and a registration period of 274 days. Other African countries present similar obstacles to registering property: Completing the transfer process takes more than a year in Ghana and 354 days in Rwanda, and costs 34 percent of the property value in Senegal and 23 percent in the Republic of Congo. Moreover, Africa's property registries tend to be poorly organized and provide little security of ownership.

Sub-Saharan Africa is also the region where it is most difficult to enforce a simple com-

TABLE 2.6 Investment climate constraints vary across Sub-Saharan Africa
(percentage of firms citing problem, unless otherwise indicated)

Country	Unpredictable interpretation of regulations	Lack confidence courts will uphold property rights	Management time spent dealing with officials (percentage of time)	Average number of days to clear customs	Finance a major constraint	Infrastructure a major constraint	Skills a major constraint
China	33.7	17.5	19.0	7.9	22.3	29.7	30.7
Kenya	45.5	51.3	13.8	8.9	58.3	48.1	27.6
Mozambique			11.3	11.9	78.0	64.0	33.5
Senegal	42.5	40.5	13.8	6.5	60.0	30.7	18.5
Tanzania	58.6	55.1	16.2	17.5	53.0	58.9	25.0
Uganda	40.0	30.1	5.0		52.8	44.5	30.8
Zambia	70.1	36.0	14.1	4.8	67.7	39.6	35.7

Sources: World Bank, *World Development Report 2005*; World Bank Investment Climate Surveys.

FIGURE 2.10 Sub-Saharan Africa lags other regions in the quality of the business environment

Source: Doing Business in 2005 database.

mercial contract through the courts. On average, creditors must go through 35 steps, wait 15 months, and pay 43 percent of their country's per capita income before receiving their due payment. The result is less access to justice and weaker protection of property rights, leading to fewer formal business transactions.

Hiring and firing workers in the formal sector in Africa is also not easy. The region has the most rigid labor regulations and among the highest firing costs.⁴² In Burkina Faso employers cannot write a fixed-term contract unless a job is seasonal; the mandated minimum wage is \$54 a month, which at 82 percent of value added per worker is the

third highest in the world; night and weekend work are prohibited; and women are not permitted to work more than 8 hours a day. If a business needs to downsize, it must notify the Ministry of Labor of its intention to retrench workers, and the law requires that redundant workers be trained and placed in other jobs prior to dismissal. If an employer follows these procedures, a redundancy costs an average of 18 months' wages in severance pay and penalties. Thus it is little wonder that many businesses operate in the informal economy, which accounts for about 40 percent of the country's output. High firing costs make employers less likely to hire.

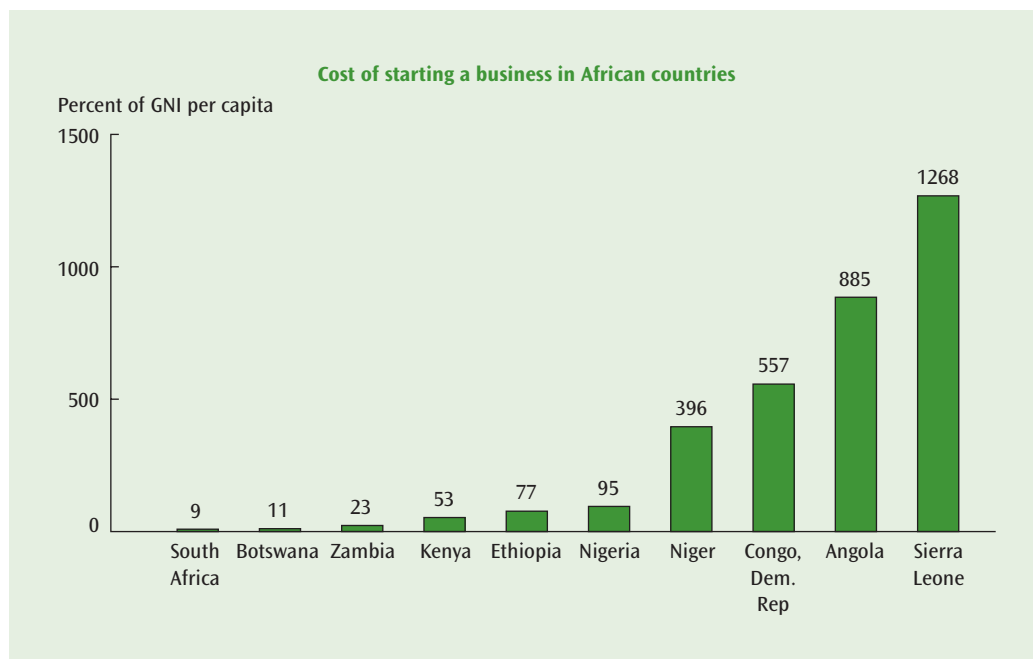
Moreover, without clearly defined property rights and efficient contract enforcement, lenders are less likely to extend credit to entrepreneurs. Although Sub-Saharan Africa performs better on indicators of legal rights for borrowers and lenders than do South Asia, Latin America, and the Middle East and North Africa, institutions that support credit markets are weak. For example, only four Sub-Saharan countries—Botswana, Ghana, Namibia, and South Africa—have private credit bureaus to provide lenders with information on a borrower's creditworthiness.

Within Sub-Saharan Africa's overall difficult business environment, however, performance varies considerably, and there are several examples of good practice. The cost of starting a business varies across countries by more than 100-fold, from 10 percent of per capita income to more than 10 times

(figure 2.11). Botswana and South Africa have low official fees, in line with those in high-income countries, while Angola and Sierra Leone have costs that are among the world's highest. In other examples of good practice, Tanzania and Uganda have commercial or small claims courts, Tanzania has a specialized court for bankruptcy, Botswana and Tanzania have no minimum capital requirement for starting a business, Madagascar and Namibia have introduced moderate severance pay for redundant employees, and South Africa gives investors access to ownership and financial data before they invest in a company.

There are also broader patterns across the region. As in other regions, middle-income countries have more efficient regulation than do low-income countries. For instance, it takes an average of 234 days to enforce a debt contract in a middle-income country, but

FIGURE 2.11 The cost of starting a business varies widely



Source: Doing Business in 2005 database.

almost twice that in a low-income country. On the other hand, business regimes tend to be most onerous in oil-dependent economies (box 2.10) and countries that have recently endured civil conflict.

Improving the Business Environment

The costs of a weak investment climate are substantial, and the impacts widespread. At the enterprise level the estimated costs, measured in terms of the share of sales lost, range from less than 10 percent in Poland to more than 30 percent in Zambia. The composition of costs also varies dramatically across countries. In Kenya, Tanzania, and Uganda weak infrastructure services are particularly burdensome, while in Zambia bribes are especially costly (figure 2.12). Priorities for reform thus vary by country.

Reform offers large payoffs. In Ethiopia annual business registrations increased by 48 percent after the process was simplified in 2003. In Namibia the cost of expanding output fell by 15 percent as a result of more flexible working hours introduced in 2003. In Mozambique commercial banks report that reforms to the public credit registry have helped provide credit to a wider set of entrepreneurs. Empirical analysis indicates that Africa could grow by an additional 1.6 percentage points a year if the average country were to improve its business regulation system to the level of the average OECD country.⁴³ Countries with better business environments tend to benefit from higher private investment: among Sub-Saharan countries that scored 50 or higher on the ease of doing business index in 2005, the correlation between that score and the rate of private investment during 1990–2003 was 70 percent. Improvements in Uganda's business environment have contributed significantly to stronger economic performance since the early 1990s (box 2.11).

While some countries in Sub-Saharan Africa are taking notable steps to improve

the private business environment, reforms need to be quickened and extended to other countries. Despite their heavier burden of business regulation and weaker protection of property rights, African countries lagged those in other regions in the scope and pace of reform achieved in the past year, as assessed by the annual *Doing Business* report.⁴⁴ Of the 58 countries in the sample that had reformed regulation or strengthened property rights, only 8 were in Africa. Most reforms in Africa were in the relatively straightforward area of starting a business, while outside Africa there were reforms in every area measured (figure 2.13).

Among Sub-Saharan nations enacting reforms, Ethiopia improved the process for starting a business by cutting the number of required procedures and reducing the associated cost and time. Madagascar slashed the time required to start a business by establishing a new one-stop shop for entrepreneurs. Benin, the Democratic Republic of Congo, Côte d'Ivoire, and Kenya also reformed entry regulation. In Mozambique a public credit registry went online, strengthening the quality of data. In contrast, some countries worsened their investment climates: actions in Malawi, Mauritania, Rwanda, and Zimbabwe raised the cost of starting a business.

Looking ahead, how can the business environment be improved in Sub-Saharan Africa? The evidence points to a broad agenda of reform, with specific priorities and sequencing varying by country. Assessments of the business environment suggest the following as key areas for improving the regulatory and institutional framework in many countries:

- *Streamlining entry regulations and cutting fees.* In Africa the official fees for starting a business are prohibitive for most would-be entrepreneurs. Cutting these fees would encourage more businesses to operate in the formal sector. To reduce the pro-

BOX 2.10 Comparing business regulations in two resource-dependent economies: Angola and Botswana

One of the manifestations of the “resource curse” is lack of economic diversification in resource-dependent economies. Among the most severe cases have been oil-dependent economies in Sub-Saharan Africa, such as Angola, where significant private investments have flowed to the oil sector (with its enclave fiscal, regulatory, and legal regime) but, for the most part, not to other sectors. Other countries, including Botswana, have been able to harness the power of natural resources by implementing sound macroeconomic and structural policies and providing adequate incentives for entrepreneurs to take up profitable opportunities in all sectors. The table below compares the regulatory burden imposed on entrepreneurs in Angola and Botswana.

Businesses face a lower regulatory burden in Botswana than Angola

Country	Starting a business		Registering property		Enforcing contracts		Hiring and firing		Getting credit		Closing a business	Protecting investors
	Days	Cost	Days	Cost	Days	Cost	Labor rigidity	Firing costs	Legal rights	Credit information	Recovery rate	Disclosure
Angola	146	885	335	11	1,011	9	75	116	3	4	1	2
Botswana	108	11	69	5	154	25	20	19	9	5	51	5

Note: Cost of starting a business is measured as a percentage of per capita gross national income (GNI). Cost of registering property is measured as a percentage of property value. Cost of enforcing contracts is measured as a percentage of debt value. Labor rigidity is an index from 0–100, with higher values indicating more rigid regulation. Firing costs are measured in number of weeks of salary due as severance payment. Legal rights is an index from 0–10, with higher scores indicating the degree to which collateral and bankruptcy laws facilitate lending. Credit information is an index from 0–6, with higher scores indicating more availability of information through public or private bureaus. Recovery rate is measured in cents on the dollar. Disclosure is an index from 0–7, with higher scores indicating more disclosure of corporate information.

Worldwide, Angola is among the 20 countries with the least business-friendly regulations, while Botswana is among the top 20. On most indicators measured by the *Doing Business* project, Botswana substantially outperforms Angola. Registering property—essential for obtaining credit in many countries—takes almost five times longer in Angola. Hiring and firing workers is considerably less flexible and more costly in Angola. And closing a business, which helps entrepreneurs start and

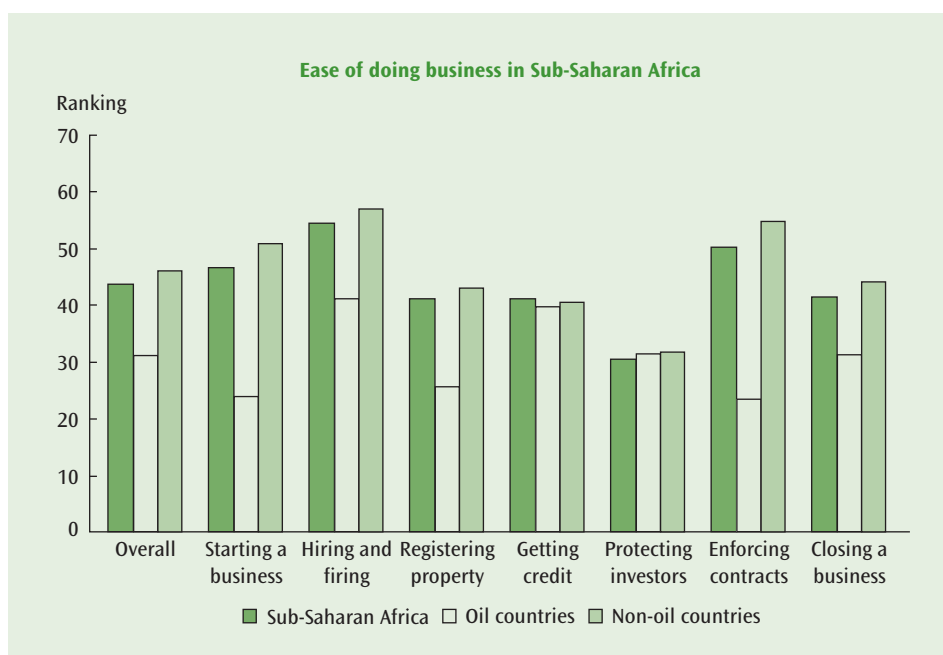
cedures and time required for business registration (which can also significantly reduce the cost), governments could also create single access points for business (as in Madagascar), introduce temporary business licenses, impose “a silence is consent” rule for business registration, and standardize paperwork.

- *Cutting fees and unnecessary procedures for property registration.* A large bottleneck in several African countries is the requirement for government consent

before property is transferred. This causes delays, usually requires an exorbitant fee, and can be a major source of corruption. Lesotho, Malawi, Nigeria, Rwanda, Senegal, and Zambia all have government consent requirements. The impact of such requirements can be considerable. For example, if Malawi eliminated the requirement of obtaining consent from its Ministry of Land (procedure 3 in figure 2.14), registering property would take 28 days instead of 118.

BOX 2.10 Comparing business regulations in two resource-dependent economies: Angola and Botswana (*continued*)

grow their businesses, is significantly more complex in Angola. Not surprisingly, Botswana has a more diversified economy and has grown roughly twice as fast as Angola over the past 10 years.



Across Sub-Saharan Africa, Angola is typical of oil-driven economies, which tend to have more cumbersome business regulations and weaker protection of property rights than do non-oil economies (see figure). Reforms in these areas could significantly enhance the attractiveness of non-oil private investment in oil economies.

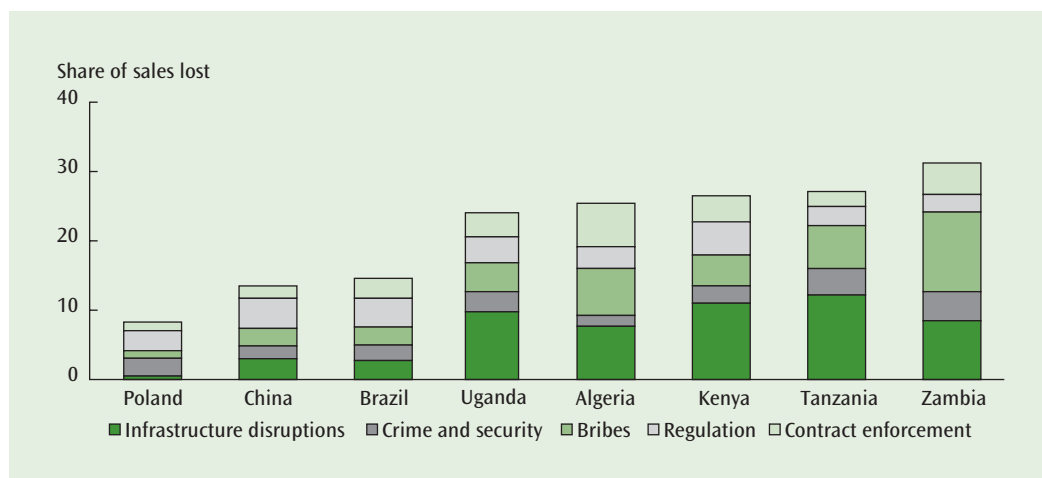
Source: Doing Business in 2005 database.

Other reforms that strengthen property rights and encourage investment include simplifying and consolidating procedures at the property registry, cutting fees, linking the cadastre and property registry, and providing easier access to information in the registry.

- *Encouraging the establishment of credit bureaus.* Access to credit would be made easier if lenders had assurance that borrowers are creditworthy (and that it is possible to recover debt, in cases of default).

By encouraging the development of credit bureaus, African governments can help furnish creditors with information to sort good from bad borrowers, price loans correctly, and reduce screening costs.

- *Making labor regulations more flexible and reducing the cost of firing.* To accomplish this, African countries can increase the length and scope of term contracts, introduce apprentice wages (following the example of Madagascar), allow flexible working hours (as in Namibia), and

FIGURE 2.12 A weak investment climate entails high costs

Sources: World Bank 2004b; World Bank Investment Climate Surveys.

BOX 2.11 High returns to investment climate improvements in Uganda

The economic successes of China and India are well known, with China growing at 10 percent a year and India having doubled its growth rate since the 1970s, following major reforms over the past two decades. But the benefits of investment climate reforms are not limited to large countries. Uganda's experience shows the importance of persistence, rather than perfection, in translating investment climate reforms into increased growth and poverty reduction. Uganda initiated its investment climate improvements in the early 1990s, after a period of civil conflict and macroeconomic instability.

Reforms covered many areas affecting the investment climate: Macroeconomic stability was achieved, expropriations by a previous government were reversed, trade barriers were reduced, and tax and court systems were strengthened. The persistence of the government's reform efforts enhanced its credibility, giving firms confidence to invest. Indeed, private investment as a share of GDP more than doubled, from just over 6 percent in 1990 to 15 percent in 2002. These improvements contributed to stronger per capita income growth, which averaged 4 percent a year in 1993–2002 (eight times the average in Sub-Saharan Africa), and a reduction in the share of Uganda's population living below the poverty line, from 56 percent in 1992 to 35 percent in 2000.

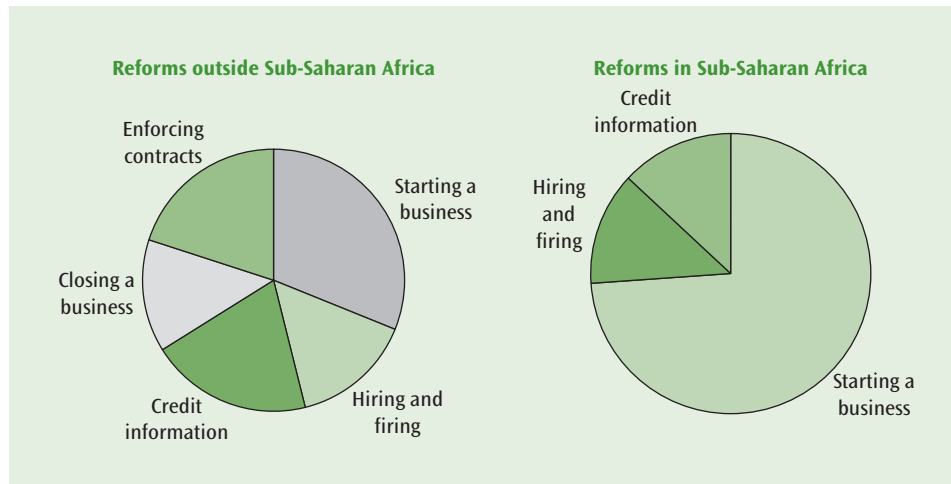
Source: Adapted from World Bank 2004b.

remove administrative approvals for dismissal.

- *Reducing unnecessary procedures and contract enforcement times.* Approaches include introducing case management (as in Uganda), reducing abuse of appeals procedures (as in Botswana), improving enforcement (in Uganda the creditor's attorney is responsible for enforcement,

with the help of the police), and creating specialized courts or sections of commercial courts (as in Ghana and Tanzania).

Some reforms, such as improvements to entry regulations, credit reporting systems, and property registries, can be achieved relatively quickly through administrative reforms. Others, such as those involving labor regula-

FIGURE 2.13 Business environment reforms need to be scaled up in Sub-Saharan Africa

Source: *Doing Business in 2005* database.

tions and court reforms, require longer-term efforts and legislative action. Investment climate reform is a process, not an event. Not everything needs to be fixed at once, or perfectly at one go. Significant progress can be achieved by addressing the more important constraints facing businesses in a way that gives them confidence to invest and by sustaining a process of ongoing improvements.⁴⁵

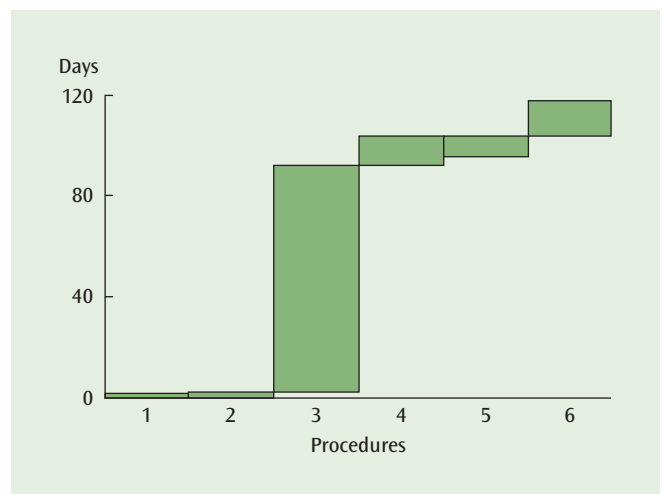
The foregoing discussion focuses on the need for regulatory and institutional reform. The evidence presented also points to lack of financial and physical infrastructure as major constraints in many countries. The next two sections focus on these aspects of the agenda.

Financial sector

Sub-Saharan Africa's financial sector has gone through major changes over the past 15 years, and has largely been transformed into an open system that includes a variety of institutions owned by domestic and foreign private entities. With the proliferation of financial institutions, the average bank size has shrunk by about 25 percent. These changes have revealed weaknesses in regulatory capacity and limitations in risk assessment within financial institutions, and many African countries have had to cope with sig-

nificant bank failures. The resolution of these failed banks through restructuring and privatizing has been the main focus of policymakers over the past 15 years.

In addition, considerable efforts have been made to improve legal and regulatory frameworks and to build regulatory capacity to prevent further failures. African banking laws and regulations are now largely comparable

FIGURE 2.14 Registering property is unduly time-consuming in Malawi

Source: *Doing Business in 2005* database.

to international standards—although the enforcement of regulatory standards is weak, as in many other developing countries. The region's reforms have achieved substantial results, and financial system stability has improved appreciably.

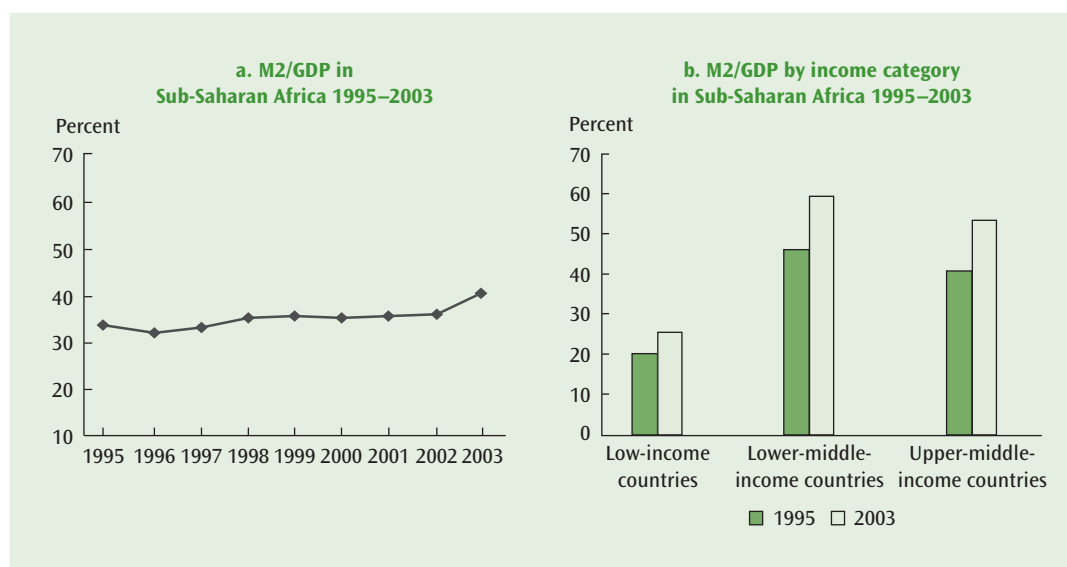
Despite this legal and regulatory progress, financial systems in Sub-Saharan Africa remain underdeveloped. Outside Mauritius and South Africa, lending to the private sector is still limited and costly. Since 1995 there has been limited progress on financial sector deepening (figure 2.15). Excluding South Africa, private sector credit relative to GDP has grown by only about 2 percentage points over the past 10 years, with most of the growth occurring recently (figure 2.16). A number of explanations have been advanced, including increased holdings of government paper by banks due to bank restructuring, crowding out, and more conservative lending in the face of high credit risks.⁴⁶ Another problem is that the cost of borrowing is higher in Sub-Saharan Africa than in other regions (figure 2.16b).

In this context, improving access to financial services poses a significant challenge. As noted,

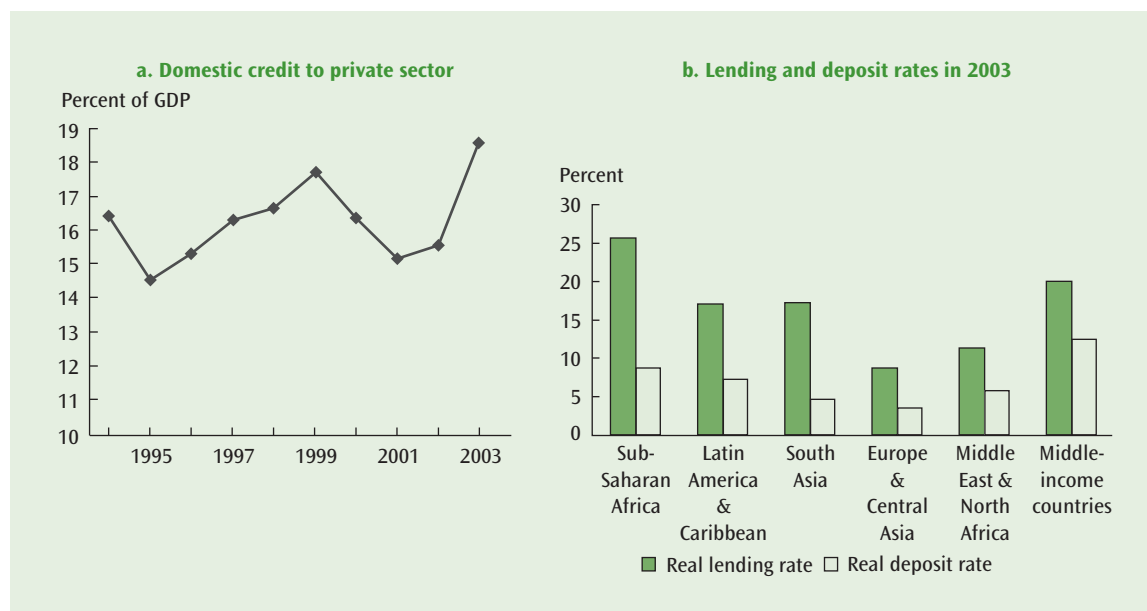
investment climate surveys in Sub-Saharan Africa reveal that inadequate access to finance is a major constraint for entrepreneurs. The surveys also indicate that access is hampered for two reasons. First, high real interest rates and banking fees make financial services too costly. Second, mainstream financial institutions fail to serve the needs of important population segments, including small-scale entrepreneurs. Virtually all surveys indicate that financial institutions are hesitant to lend because of difficulties in securing collateral and seizing assets in case of default. The availability of financial services is also crucially related to financial system supporting structures, including regulation, information infrastructure, property rights enforcement, and overall governance and institutional development.

There have been notable efforts to develop credit information systems and improve regulations to facilitate access to finance.⁴⁷ The World Bank has documented the incipient development of credit reporting systems in 30 Sub-Saharan countries, including systems operated by private firms in Botswana, Cape Verde, Equatorial Guinea, Eritrea, and Namibia. A number of countries have

FIGURE 2.15 Financial depth is lowest among low-income Sub-Saharan countries



Source: World Bank Staff estimates.

FIGURE 2.16 The cost of borrowing is higher in Sub-Saharan Africa

Source: World Bank staff estimates.

improved their regulatory systems to facilitate access to finance, notably legal rights for creditors in Kenya, Nigeria, and Zimbabwe and registration of movable collateral in Botswana and South Africa. In addition, Ghana, Kenya, Mauritius, Tanzania, and Uganda have introduced regulations to facilitate the integration of microfinance institutions with mainstream financial systems. These are all promising efforts, as development of financial infrastructure can secure access to credit for a wider segment of the population.

Most African countries receive (bilateral and multilateral) donor-funded facilities for trade and investment finance purposes. When these facilities are implemented effectively, they substantially enhance domestic private sector credit (as in Zambia). But experiences with donor-funded financing vehicles have shown the need for terms and conditions more consistent with long-term goals for financial sector development. Donor-funded facilities that are priced below market rates, targeted to specific sectors and borrowers, and channeled through a few select interme-

diaries do not provide an adequate framework for promoting efficient resource allocation. Coordination among providers of these facilities and harmonization of terms and conditions are among the most important challenges for donor-funded facilities to improve financial intermediation.

Physical infrastructure

Inadequacies in the level and quality of infrastructure—including electricity, transportation, and communications—can adversely affect private sector productivity and investment rates. While macro evidence on the growth impacts of infrastructure remains somewhat inconclusive, businesses in developing countries often cite infrastructure quality among their top constraints, particularly in Sub-Saharan Africa and South Asia. For example, entrepreneurs in Sub-Saharan Africa consider unreliable electricity one of their biggest constraints (see figure 2.9). Transport infrastructure is also key in the region, given its long distances and many landlocked countries. But the wide variation

in survey responses across developing countries suggests that the severity of the constraints imposed on the private sector by inadequate infrastructure differs considerably.⁴⁸ In particular, in some countries a lack of sufficient maintenance, rather than a lack of infrastructure, is the more pressing issue.

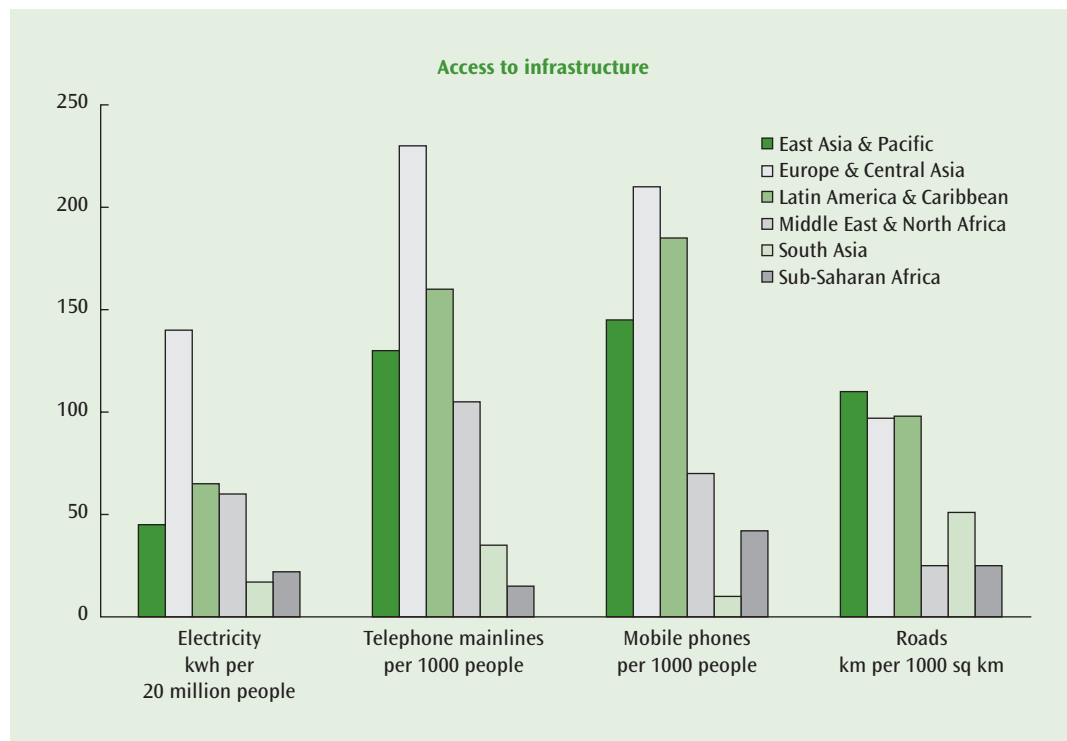
Sub-Saharan Africa and South Asia have the lowest access to basic infrastructure such as water, electricity, communications, and roads (figure 2.17). Even when services are available, their quality tends to be quite poor. Moreover, the quality of electricity and roads declined during the 1990s.⁴⁹

Estimates of infrastructure gaps for the developing world indicate sizable investment needs and large financing gaps. These gaps increased in many developing countries in the 1990s as public investment in infrastructure fell and private investment failed to rise suffi-

ciently to take up the slack. Recent projections indicate that Sub-Saharan Africa has investment needs of \$17–22 billion a year in 2005–15, including both capital and maintenance expenditures.⁵⁰ Estimates place current public infrastructure investment at about \$6 billion a year (roughly half of which is donor-financed) and private commitments at about \$4 billion a year. Thus the region's infrastructure financing gap is \$7–12 billion a year, or 4.5 percent of GDP (figure 2.18).

Under current conditions it is unlikely that infrastructure projects involving private participation will fill a significant portion of Sub-Saharan Africa's financing gap. Due to its relatively low level of private involvement, the region escaped the retrenchment of private participation in infrastructure that occurred throughout the developing world in the late 1990s (figure 2.19). But

FIGURE 2.17 Weak access to infrastructure is a major constraint in Sub-Saharan Africa and South Asia



Source: World Development Indicators database.

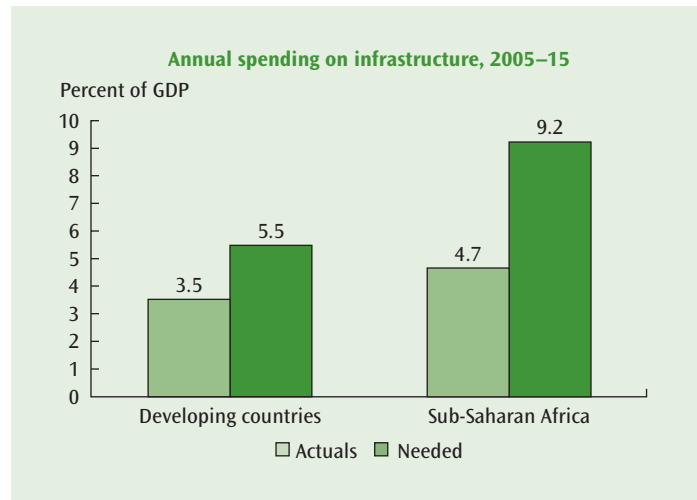
Africa's initial experience with private participation was unsatisfactory in two key respects. First, private participation was below government expectations. Second, a number of contracts were subsequently renegotiated or cancelled. In general, private investors perceived a high level of operational and political risk, particularly because of the lack of reliable information on the operational and financial outlook. Moreover, the bulk of projects were implemented in South Africa.

Long-term success will require ensuring an enabling regulatory environment for both private and public projects. In this respect, three challenges appear crucial. First, it is important to strike an adequate balance in government budgets between capital and recurrent spending. Politicians tend to find more satisfaction in opening new facilities—but throughout the developing world, a maintenance deficit tends to significantly shorten the lifespan of expensive equipment. Second, it is essential to ensure the financial viability of infrastructure projects, with a focus on full cost recovery. It is notable that South Africa, which has made enormous progress in expanding water and sanitation services, has a policy of full cost recovery. Third, it is essential that returns not be confiscated by the government. A major risk for private-public partnerships is that governments will renege on commitments to cost-recovering tariffs once fixed investments are sunk. Addressing these concerns requires careful design of the contracts and regulatory environments under which utilities operate.

Public Sector Governance: The Role of Institutions

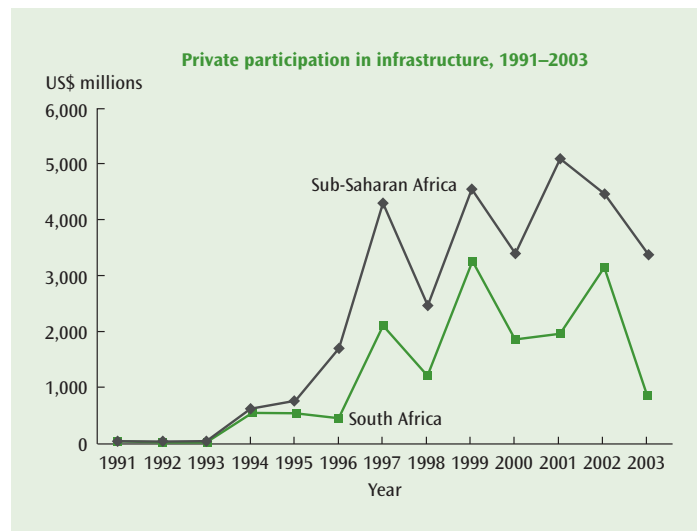
Public sector governance has a significant impact on economic outcomes, such as growth and poverty reduction, and on the achievement of the nonincome MDGs. In many ways improving governance is the biggest challenge facing developing countries.

FIGURE 2.18 Infrastructure spending fails to meet needs, particularly in Sub-Saharan Africa



Source: Estache and Yepes 2004.

FIGURE 2.19 Private participation in infrastructure remains low in most Sub-Saharan countries, and has recently fallen



Source: Private Participation in Infrastructure database (World Bank).

Building on the earlier discussion on the need for sound public financial management and an enabling environment for private sector activity, this section assesses progress in strengthening a broader set of institutions—economic and political—that affect economic outcomes.

Economic Governance

The perception that economic governance is weaker in Sub-Saharan Africa than in other regions is broadly supported by available indicators. For example, the Worldwide Governance Indicators, a comprehensive set of measures compiled by the World Bank and based on information from a wide set of sources, show weak performance in Sub-Saharan Africa on four critical governance issues—rule of law, voice and accountability, government effectiveness, and control of corruption—throughout the period covered, 1998–2004. The only exception is voice and accountability, where Sub-Saharan Africa slightly outperforms the Middle East and North Africa and South Asia. Country Policy and Institutional Assessments (CPIAs), developed by World Bank staff, paint a similar picture, with Sub-Saharan Africa rated lower than all other developing regions on property rights and rule-based governance, quality of budgetary and financial management, efficiency of revenue mobilization, and quality of public administration.

Crucially for investment flows, the perceptions presented by these indicators are confirmed by the risk assessment services commonly used by private investors. For example, the composite risk index from the International Country Risk Guide (ICRG) rates Sub-Saharan Africa as the highest-risk region during 2000–3 (and consistently since the inception of the group's assessments in the 1980s).⁵¹ This overall rating is consistent with the results of the previous section as well as low scores on key economic governance dimensions such as bureaucratic quality, corruption, and law and order.

Moreover, while there has been some improvement in recent years on a few indicators in some Sub-Saharan countries, econometric evidence confirms that the region's countries tend to underperform on governance, relative to their income levels. Recent claims to the contrary suggesting that the perception of weaker governance in Africa is due entirely to low income levels assume that

higher income leads to better governance; these claims ignore the effect of potential causality from governance to income levels. Yet empirical evidence suggests that the stronger causality effect is from governance to income and, once that is accounted for, most African countries have governance scores lower than would be expected on the basis of their income levels (box 2.12).

Within this general assessment, disaggregation of the previous indexes by income level reveals important differences across African countries. While low-income countries in Sub-Saharan Africa are assessed as having weaker performance than their counterparts elsewhere, the eight middle-income Sub-Saharan countries outperform other middle-income countries. This result holds for the Worldwide Governance Indicators and the CPIA scores, as well as the ICRG risk assessments.⁵²

Political Governance and Accountability

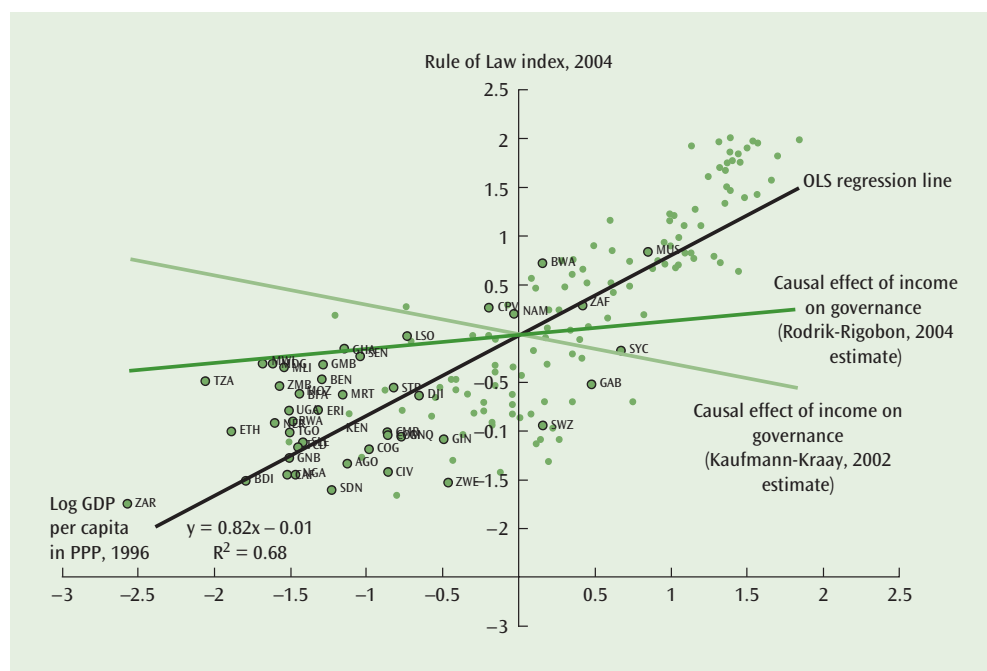
On political governance, Sub-Saharan Africa's performance is stronger, with indicators generally ranking it ahead of some other developing regions. For example, on Freedom House's 2005 rankings of political rights and civil liberties, Sub-Saharan Africa is rated "more free" than the Middle East and North Africa and South Asia. More impressively, the Database on Political Institutions maintained by the World Bank shows that by 2002, Sub-Saharan Africa attained a higher percentage of countries with chief executives selected through competitive multiparty elections than the average for other developing regions (figure 2.20). Finally, the African Governance Indicators, compiled for the United Nations Economic Commission for Africa's 2005 *African Governance Report*,⁵³ confirm the region's higher scores on the political dimension and lower scores on economic governance (box 2.13).

On press freedom, a key indicator of political accountability, the picture is similar. A well-informed citizenry has been called the "ultimate constraint on a democratic government,"⁵⁴ and recent evidence points to the role of the media in promoting

BOX 2.12 How does governance affect per capita incomes in Africa, and vice versa?

A recent paper argues that weak governance is not a major factor in Africa's poor growth performance (Sachs and others 2004). The argument is that, once their (low) level of income is accounted for, Sub-Saharan countries do not have particularly poor governance indicators. This point is illustrated in the figure below, which plots the rule of law measure from the Worldwide Governance Indicators (on the vertical axis) against the logarithm of real per capita GDP in the mid-1990s (on the horizontal axis). Sub-Saharan countries are identified by green dots outlined in black. A striking observation is that more than half (27 of 46) of the countries in the region fall above the (ordinary least squares, or OLS) regression line, shown in black. The conclusion drawn by Sachs and others (2004) is that, with more than half of the countries in the region performing better on governance than would be predicted by their income, the perception of weak governance in Africa is simply a reflection of low income levels.

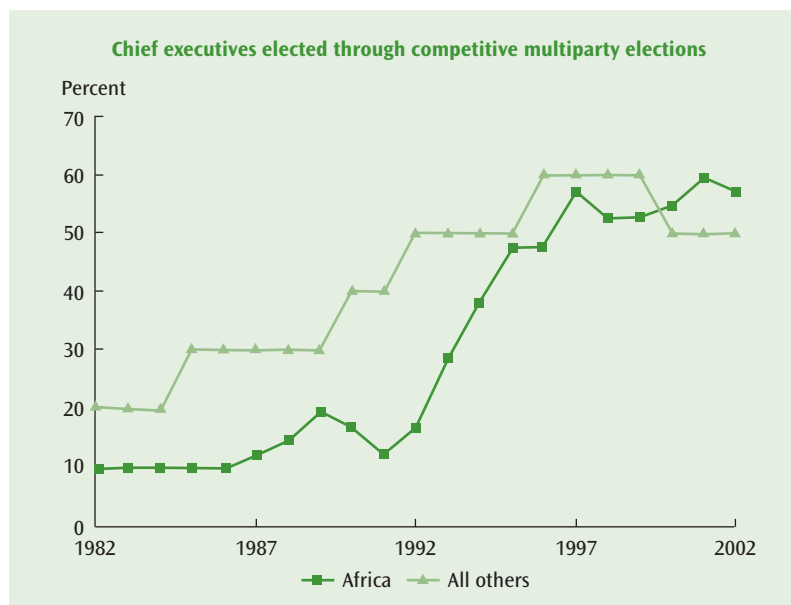
But the simple correlation portrayed by the OLS regression line does not imply causality. The above argument assumes that higher income leads to (or causes) better governance. Intuitively, however, causality could run in the opposite direction, with better governance leading to higher income—or, more likely, in both directions. In either case, the OLS results do not isolate the different directions of causality and do not support any conclusion on the causal relationship between governance and income.



On the other hand, the green lines are drawn from two attempts to effectively identify the direction of causality. The upward-sloping green line is from Rigobon and Rodrik (2004) and the downward-sloping green line from Kaufmann and Kraay (2002). Although the two estimates use different approaches to identification, the conclusions are similar: Very few countries (7 and 6, respectively) fall above the regression line. Thus the evidence suggests that governance in Sub-Saharan Africa is not as good as one might expect given the level of per capita income.

Source: Kaufmann, Kraay, and Mastruzzi 2005.

FIGURE 2.20 Participatory processes are improving in developing countries, but most rapidly in Africa



Source: World Bank Database on Political Institutions.

Note: The index measures the percentage of country leaders elected in multiparty elections with less than 75 percent of the vote. The category “all others” includes developing countries in all other regions except Europe and Central Asia (for lack of comparable data for that region for the early part of the period covered).

good governance and holding governments responsive and accountable.⁵⁵ For 2004 the Freedom House indicator of press freedom ranks Sub-Saharan Africa (with 50 percent of countries ranked as “not free”) ahead of both the Middle East and North Africa (100 percent) and South Asia (75 percent).

Is Governance Improving?

On economic governance, there is little evidence of regionwide improvement. The Worldwide Governance Indicators do not provide any evidence of a relative improvement over the period covered, 1998–2004.⁵⁶ Similarly, the most common ICRG indicators (bureaucratic quality, corruption, law and order) show no improvement over time, while the CPIAs show only marginal improvement.⁵⁷ The same pattern of stagnation holds for both low- and middle-income Sub-Saharan countries.

On the other hand, there have been substantial improvements in political institutions across Sub-Saharan Africa. Since 1990 Freedom House indexes on political rights and civil liberties in Africa have outpaced the general trend toward more inclusive and open political systems; similar indications are provided by the polity index on democracy. As noted, equally positive has been the progress suggested by the World Bank’s Database on Political Institutions, according to which Sub-Saharan Africa has made impressive strides since the mid-1990s.

Can Policy Spur Institutional Reform?

Although institutions tend to persist, they are not predetermined.⁵⁸ Economic institutions have improved considerably in Chile and the fast-growing countries of East Asia, and there is evidence of recent improvements in political institutions across Sub-Saharan

BOX 2.13 The Economic Commission for Africa's governance indicators and agenda

The African Governance Indicators, compiled as part of the United Nations Economic Commission for Africa's (UNECA's) *African Governance Report 2005*, offer interesting insights on the strengths and weaknesses of different governance dimensions in Africa. Based on surveys of 25 Sub-Saharan countries, the figure below shows that, on average, the highest scores are given for indicators of political representation: the credibility of the electoral process, the freedom of political parties, and the distribution of political power. Average scores were lower for the effectiveness of institutions in all three branches of government (executive, judicial, legislative). Scores were lower still for the efficiency of government services, the control of corruption, and the transparency and accountability of the civil service. Scores were lowest for the decentralization of government structures and corruption in the tax system. Generally, these assessments are consistent with the thrust of the earlier discussion on economic and political governance.

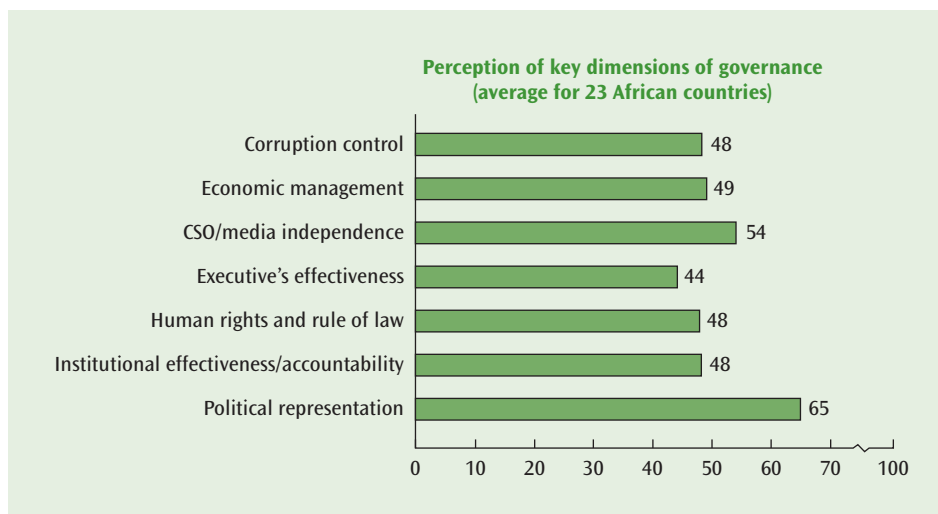
The report identifies 10 priority areas in building capable and accountable states:

- Strengthening the capacity of parliaments to perform their core functions, including providing checks and balances on the executive. Parliamentarians and their support staff need training and access to libraries and databases.
- Deepening legal and judicial reforms, including through protection and enforcement of the autonomy of the judiciary and modernization of the judicial process. The judiciary needs independent funding. Reforms must also cover the police force and public prosecutors.
- Improving public sector management through long-term, sustained efforts, tailored to country needs—for example, reducing red tape, accelerating improvements in pay and other incentives, and using in-country, regional, and international knowledge hubs.
- Improving the delivery of public services, through effective channels of accountability between public providers and their clients. Options include decentralizing and encouraging greater choice and competition.
- Removing bottlenecks to private enterprise, to improve national and regional investment climates. This requires macroeconomic stability, consistent policies and regulations for business entry, protection of property rights, and enforcement of contracts.
- Tapping the potential of information and communication technologies for promoting transparency, openness, and knowledge exchange in the affairs of government. Due to high costs, a strategic approach to e-governance is needed.
- Fostering credible and responsible media that report accurate information and stimulate debate in an environment of freedom. Training is needed to support professionalism and effective self-regulation by the media.
- Maximizing the contribution of traditional modes of governance. Traditional authorities must be enabled to complement the resources of government in providing public goods and services, including for conflict prevention and resolution.
- Confronting the governance dimension of HIV/AIDS, which requires strong national leadership to reduce the effects of the pandemic on institutional structures and to manage the resources and mechanisms needed for societywide responses.
- Getting partners to live up to their commitments for more and better aid through harmonized procedures, budget support, and predictable disbursements. Policies on aid, trade, and debt must be consistent with African efforts to achieve the MDGs.

This ambitious reform agenda will require considerable contributions in the area of political commitment and supporting actions from donors, including assistance for capacity development. On every dimension, international financial institutions, in concert with bilateral donors, have launched initiatives to assist steadfast reformers push ahead.

BOX 2.13 The Economic Commission for Africa's governance indicators and agenda (*continued*)

Stronger performance on political representation; weaker performance on public sector management and institutional effectiveness



Source: UNECA (2004).

Notes: The scale is from 0 to 100, where scores close to 100 reflect good governance as perceived by the survey respondents.

CSO = Civil Society Organizations.

Africa. At times, crises or changes in leadership have led to institutional change, but these are not amenable to policy guidance. More applicable is the possible role of policy in promoting improvements in economic or political institutions.

In general, policies that open up economic opportunities to a circle wider than the initially entrenched elite tend to be conducive to institutional improvement. An improved investment climate tends to spur demand for wider institutional reforms because as “investors, whether domestic or foreign, come forward, they tend to demand more effective institutions, greater security, and constant improvements in the provision of public goods, which further enhances the quality of the investment climate.”⁵⁹ Along the same lines, a number of studies have found that strengthening competition, including through trade openness, can be conducive to institu-

tional improvement.⁶⁰ Opening up new markets may reduce the rents derived from the prevailing economic and institutional arrangements and thus weaken vested interests.

There is also evidence that the wide availability of independent sources of information tends to encourage accountability. Where ownership of press outlets is monopolized by the government, political and economic freedom tends to be lower and corruption higher—and when there is more information available on policy choices and outcomes, governments tend to be more responsive.⁶¹ In a prominent case, Amartya Sen drew a link between the impact of transparency on the relative incidence of poverty and famine in China and India.⁶² The combination of higher transparency of public decisions and press freedom to stoke the public debate tends to constrain the options available to policymakers and reduce the scope for institutional failure.

In some cases external anchors may also contribute to institutional change. In combination with domestic commitment to reform, external incentives, constraints, and agreements may help in breaking through entrenched interests and other domestic impediments to reform. This has been true in the case of accession to the European Union for new members in Central and Eastern Europe, to the North American Free Trade Agreement (NAFTA) for Mexico, and to the World Trade Organization (WTO) for China. In Africa the New Partnership for Africa's Development (NEPAD) aims to use collective commitments and peer pressure to promote institutional reform (see below). Concessional loans and technical assistance from international financial institutions are also geared to improving the policy and institutional framework in borrowing countries.

Priorities for Building Capable and Accountable States in Africa

Across Sub-Saharan Africa there is growing recognition of the critical role of good governance, and a renewed resolve to improve performance on the ground. Under the aegis of NEPAD, African states have agreed to improve their economic and political governance. The work of regional development agencies is focusing more on governance, and the United Nations Economic Commission for Africa's 2005 *African Governance Report* represents a major contribution to the buildup of a critical mass of country-specific data and analysis on governance achievements and challenges. On the ground, NEPAD continues to advance with the African Peer Review Mechanism (APRM), its innovative approach to improving governance.

Already, 23 countries—containing about three-quarters of the population of Sub-Saharan Africa—have acceded to the APRM, a key objective of NEPAD since its inception in 2001. Under the APRM, African countries volunteer to “open their books” on political governance, economic governance, corporate governance, and socioeconomic development.

The underlying objective is to foster the adoption of policies, standards, and practices that lead to political stability, high economic growth, sustainable development, and accelerated subregional and continental economic integration through sharing of experiences and reinforcement of successful and best practice.

In 2004 NEPAD heads of state approved Ghana, Kenya, Mauritius, and Rwanda as the first countries to be exposed to the APRM reviews. The second group of countries to be reviewed will include Algeria, Mali, Mozambique, Nigeria, Senegal, and South Africa. The four countries that have started the review process have established focal points (at ministerial level or higher) for the APRM as well as national coordinating mechanisms to secure widespread consultations through all APRM stages. The extended design of the APRM process emphasizes learning and seeks to build more inclusive processes than are typically found in, for example, poverty reduction strategy (PRS) formulation and implementation.

Recent changes in approach have considerably lengthened the process, and the focus has changed from the regional to the country level. With the limited capacity of the APRM secretariat to prepare background analyses of countries and to promote substantive, political discussions on governance problems in the individual countries as well as in the Peer Review Panel and Forum, the APRM faces the challenge of moving beyond formal consultations and extended processes. These are critical challenges for the APRM as the most innovative and potentially influential component of NEPAD.

In the period ahead, it will be essential to translate the recent improvements in political institutions to similar enhancements in economic institutions, particularly in rule-based governance and protection of property rights. Extending reforms to these critical dimensions of governance would begin to set in motion a virtuous circle consisting of renewed incentives for better policies, a more favorable environment for private investment, and rising living standards. Better policies can play a role in

spurring institutional development, including by helping to overcome resistance to change from entrenched interests. In practice, political commitment will be key in ensuring that reforms extend beyond mere changes of formal laws to more fundamental transformations of daily practice, including informal rules of behavior and the impact of vested interests.

Notes

1. The scenario presented is based on current trends and primarily useful as a reference point.
2. The tsunami that hit Indian Ocean countries in December 2004 caused a human tragedy of epic proportions. The quick humanitarian and financial response of the rest of the world helped the affected countries quickly launch the recovery and reconstruction process and also helped limit the economic and financial costs of the tragedy. Based on initial assessments, the macroeconomic impact is expected to be modest for India, Indonesia, Sri Lanka, and Thailand. Although the impact on growth and inflation will also be modest in the Seychelles, the economy was not as robust as in the other countries prior to the disaster, and there may be increased pressure on the fiscal position and the balance of payments in 2005. In the Maldives, where the physical destruction was also significant, the macroeconomic impact may be more pronounced, with initial estimates suggesting that output in 2005 may be lower than forecast by some 5 percentage points of GDP. Somalia was also affected by the disaster, but the relative lack of information and absence of an internationally recognized government operating in the country have slowed the pace of assessments, which are currently under way.
3. In addition, for some regions the \$1 a day poverty line may underestimate the extent of poverty. Using a \$2 a day definition of poverty, the headcount measure for East Asia and Pacific would be 69.9 percent for 1990 and 11.3 percent for the 2015 forecast, for Europe and Central Asia it would be 4.9 percent and 5.2 percent, and for Latin America and the Caribbean it would be 28.4 percent and 19.6 percent.
4. This section draws on IMF (2005b).
5. The figure excludes Europe and Central Asia, for which membership has varied considerably across the period covered, and Middle East and North Africa, where heavy reliance on oil com-

plicates regional comparisons. In either case, the relevant conclusions are robust to their inclusion.

6. Equatorial Guinea should also be included in this group, but its period average growth rate has been heavily influenced by spectacular oil-led growth since the mid-1990s.

7. The estimates of inequality and the argument on the political economic consequences of observed patterns across Africa are both from Artadi and Sala-i-Martin (2003). The same study points out that most of the inequality in Africa can be accounted for by inequality within countries rather than across countries.

8. The major oil producers in Sub-Saharan Africa are Angola, Cameroon, Chad, Republic of Congo, Equatorial Guinea, Gabon, and Nigeria.

9. Bosworth and Collins (2003, p. 8).

10. See Bosworth and Collins (2003) and Tahari and others (2004). Growth in total factor productivity reflects not just changes in economic efficiency, but also the influence of growth determinants not otherwise included in measured changes in physical or human capital, including political instability and conflicts, droughts and other exogenous shocks, and changes in government policies and institutions.

11. While HIV/AIDS prevalence rates differ widely across countries, ranging from 1 to almost 40 percent, average life expectancy across the region has fallen over the past 15 years, largely due to HIV/AIDS. The primary effect of HIV/AIDS is an increase in mortality and a deterioration in health, primarily among young adults. In turn, HIV/AIDS affects most of the common indicators of living standards, such as income, health standards, and access to education—and success in combating HIV/AIDS, along with other communicable diseases, is one of the MDGs. The channels through which the disease affects economic growth are not well understood. Studies focused on disruptions to the production process, and additional health expenditures tend to find modest effects. On the other hand, studies that have attempted to capture some of the microeconomic impacts associated with the disease find a larger effect on economic growth owing, for example, to disruptions in the process of accumulating human capital (Haacker 2004).

12. The earlier spotlight on unique drivers of African growth has given way to a more complex explanation as the empirical relevance of the “African dummy” has been eliminated and a more policy-relevant dialogue has focused on the

underlying determinants of economic outcomes. See, for example, Hoeffler (2002).

13. Satyanath and Subramanian (2004) attribute the causes of long-run macroeconomic instability to the incidence of conflict, lack of openness to trade, and ineffective political institutions. This raises the general question of the extent to which macroeconomic policy is a function of deeper determinants and thus not an independent driver of growth. It is clearly the case that macroeconomic performance is partly driven by deeper political, economic, and structural factors. But a variety of evidence, including case studies and experience, suggests that there is an important role for macroeconomic policy itself. In any case, both macroeconomic policy and underlying institutional policies must be addressed simultaneously.

14. Artadi and Sala-i-Martin (2003); Tsangarides (2005).

15. The impact of foreign aid on recipient countries has been a controversial question in the academic literature, with earlier results often found not to be robust to changes in sample or specification. Recently, Clemens, Radelet, and Bhavnani (2005) found that economic aid raised growth in Sub-Saharan Africa, but they also found evidence of diminishing returns to aid. By their estimates, raising aid to Sub-Saharan Africa from current levels to the point at which marginal returns diminish to zero, at close to 17 percent of GDP, would raise growth in the region by 0.4 percent per year. Rajan and Subramanian (2005) find no evidence that aid is associated with growth.

16. See Collier, Hoeffler, and Soderbom (2004) on duration, Collier and Hoeffler (2004a) on the costs, and Staines and others (2005) on the macroeconomics of recovery from conflict.

17. Growth accelerations are defined in box 2.6.

18. The lower incidence of growth accelerations in Sub-Saharan Africa does not seem to be attributable to the region's higher proportion of low-income countries. Measured by the percentage of country years spent in acceleration episodes, the incidence of growth accelerations has been unrelated to either the initial level of income per capita or the initial savings rate—a result that holds for both the overall sample of countries and for those in Sub-Saharan Africa.

19. The cutoff at 1998 is imposed to allow calculation of the post-episode five-year average.

20. Hausmann, Pritchett, and Rodrik (2004) find that statistical models tend to have modest explanatory power but that political regime

changes, macroeconomic stabilizations, and positive terms of trade shocks tend to be statistically significant predictors of accelerations, and that sustained booms tend to be associated with economic reform rather than external shocks.

21. World Bank (2005).

22. In heavily indebted poor countries, debt sustainability is closely linked to the attainment of the completion point under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative. In addition, successful implementation of the new Bank-IMF forward-looking debt sustainability framework for low-income countries will be critical. This in turn will require an adequate supply of grant financing. These issues are discussed in chapter 5.

23. The fragility of fiscal sustainability with respect to domestic financing is illustrated by several African countries that saw sharp increases in domestic real interest rates as domestic debt levels rose from very low levels to amounts that would not typically be considered excessive in more developed economies. The examples of Ghana, Malawi, and Zambia show how even what look like relatively small increases in domestic debt can sharply increase real interest rates.

24. There is no universal definition of a successful stabilization (that is, a post-stabilization) country. Adam and Bevan (2005) suggest that inflation rates lower than 15 percent for at least two years are sufficient for qualification as a successful stabilization. Gupta and others (2002) propose a combination: fiscal deficits under 2 percent of GDP and inflation rates under 10 percent. A forthcoming IMF study advances a more comprehensive measure: some degree of internal macroeconomic balance, proxied by positive per capita growth rate and low inflation; a fiscal stance that is sustainable over the medium term, proxied by restricted domestic financing of the budget deficit; and robustness to external shocks, proxied by the level of international reserves.

25. IMF (Forthcoming).

26. Using the alternative indicators of the fiscal balance to assess progress in Sub-Saharan Africa would tend to reduce the number of countries considered successful stabilizers.

27. Despite the caveats mentioned in the text on the applicability of overall fiscal deficits to assess the sustainability of fiscal positions in Sub-Saharan Africa, it is worth noting that empirical estimates of the deficit-growth nexus yield a substantively similar conclusion in suggesting that some African countries could boost growth with a reduction in fiscal deficits. Recent studies indicate

that post-stabilization countries with low deficits may not benefit from further fiscal consolidation. However, most countries in Sub-Saharan Africa have a fiscal deficit higher than the threshold of 1.5–2.5 percent of GDP (Adam and Bevan 2005). At the end of 2003 there were 25 countries in Sub-Saharan Africa with a fiscal deficit, including grants, higher than 2.5 percent of GDP, with 13 countries exceeding 5 percent. Among the latter group, the growth rate per capita was 0.9 percent in 2003, compared with the regional average of 1.2 percent.

28. As of April 2004 this group included Botswana, Cape Verde, Equatorial Guinea, Gabon, Mauritius, Namibia, Seychelles, Swaziland, and South Africa.

29. World Bank (2005, chap. 3, p. 16).

30. Within Sub-Saharan Africa the pattern of relative underallocation toward capital expenditures and the social sectors is particularly striking in the oil economies, which tend to underinvest relative to other countries in the region.

31. The data, contracts, and audit reports are available at <http://www.mefb-cg.org>.

32. Le Houerou and Taliencio (2002, p. 35).

33. IMF (2005a).

34. IMF (2003).

35. Tax reform could also contribute to policy stability by helping to moderate the relatively large variance of revenue ratios in African countries. This tendency for greater variability effectively reduces the level of sustainable debt, among other things.

36. As noted, sustainable policy configurations, by promoting private investment and economic growth, can be an effective source of fiscal space.

37. Bulir and Lane (2002) document that aid has been up to seven times more volatile than domestic fiscal revenue, and that aid disbursements have not been well predicted by aid commitments.

38. See, for example, Levine and Renelt (1992) on the robustness of investment in cross-country regressions, and Collier and Gunning (1997) on the conclusion that investment in Africa is low.

39. For example, Devarajan, Easterly, and Pack (2001) and, more recently, Eifert, Gelb and Ramachandran (2004). Arguably, the reported high level of capital flight from Sub-Saharan Africa could be seen as a rational response to the lack of profitable investment opportunities at home (Collier, Hoeffler, and Pattillo 1999).

40. The Investment Climate Surveys and the assessment of business regulations in *Doing Business*

2005 were conducted by the World Bank in collaboration with local partners. There have been 8 surveys completed by countries in Sub-Saharan Africa, in a total of 53 across all developing regions, and 8 more are planned over the next year. The goal of the exercises is to assess the impact of the investment climate on firm performance, and to measure business regulations across the world and benchmark best practices. *Doing Business* 2005 covers 145 countries, including 32 in Sub-Saharan Africa.

41. The ease of doing business index is the simple average of country rankings (from 1-135) in each of the seven measures included in *Doing Business* 2005, with higher values indicating more efficient regulation and stronger protection of property rights.

42. Labor regulation rigidity is the average of the difficulty of hiring index, rigidity of hours index, and difficulty of firing index. This indicator ranges from 0-100, with higher values indicating more rigid regulation.

43. Djankov, McLiesh, and Ramalho (2004).

44. *Doing Business* in 2005.

45. This a key message of World Bank (2004b).

46. Hanson and Ramachandran (2004).

47. *Doing Business* database.

48. There are, of course, other good reasons to prioritize investments in infrastructure, such as enhancing service delivery and accessibility in line with the nonpoverty goals of the MDGs; these are discussed in chapter 3.

49. Estache and Goicoechea (2004).

50. Estache and Yepes (2004).

51. The International Country Risk Guide (ICRG) economic risk index is a weighted average of measures on political, economic, and financial risk components, with the values ranging from 0-100, where a higher score indicates lower risk. During 2000-3 the median rating for Sub-Saharan Africa was 59, followed by South Asia at 62, Latin America and the Caribbean at 67, East Asia and the Pacific, Europe and Central Asia, and the Middle East and North Africa at 70, and high-income countries (OECD and others) at 82.

52. On the ICRG economic risk index, low-income countries in Sub-Saharan Africa have a risk assessment of 31.0, compared with 33.5 for other low-income countries (where a lower score implies a higher risk). On the other hand, the same index rates middle-income countries in Sub-Saharan Africa at 36.5, compared with 35.5 for other middle-income countries.

53. United Nations Economic Commission for Africa: *Striving for Good Governance in Africa*. Synopsis of the 2005 African Governance Report (Prepared for the African Development Forum IV, Addis Ababa, October 2004; <http://www.uneca.org/agr/>).

54. McMillan and Zoido (2004, p. 87).

55. Besley and Burgess (2004); Djankov and others (2003).

56. These indicators are not, strictly speaking, designed to show progress over time, but they do indicate whether a region is making progress relative to others over time.

57. The improvement in CPIAs during 1999-2003 is marginal in two senses: relative to the

average improvement in other regions and, statistically, relative to the standard deviation.

58. This section draws on IMF (2003).

59. Stern (2001).

60. See, for example, Ades and Di Tella (1999), Berg and Krueger (2003), Djankov and others (2001), Wei (2000), and World Bank (2002).

61. See, for example, Djankov (2002), Adserà, Boix, and Payne (2003), and Brunetti and Weder (2003) on the relationship between the press and governance, and Besley and Burgess (2002) on the relationship between government responsiveness and newspaper circulation.

62. Sen (1995).

Scaling Up Service Delivery

The chance for every child to go to primary school. A place to go for medicine and basic health care. Clean water flowing from a tap. Sanitation. Electricity at the turn of a switch. These basic services are taken for granted by citizens of developed countries. Yet in much of the developing world—even for relatively wealthy groups—these services are either unavailable or available only at low quality or high private cost.

The human development outcomes at the core of the Millennium Development Goals (MDGs)—primary education, literacy, gender equality, good health—depend on access to these basic services. Human development outcomes are also influenced by many other factors, such as individuals' traits and family backgrounds, community features (including roads and communications), and country characteristics (including income, demography, geography, and history). But striking differences in these outcomes across countries can be explained to an important degree by the policy choices that governments make to shape the financing and delivery of the basic education, health, water, and sanitation services that directly affect human development.

This chapter assesses the progress that countries and regions are making toward the human development MDGs, focusing on the three most difficult implementation challenges for most countries:

- Scaling up skilled providers—the doctors, nurses, and teachers needed to rapidly expand health and education services.
- Ensuring the sustained financing required to expand these recurrent cost intensive services.
- Making sure that resources translate into effective service delivery, by improving governance and accountability.

This selective focus means that the chapter gives less attention to many other issues—such as social protection, population trends, pharmaceutical availability, and school construction—that are also important for MDG progress. The goal is to complement other analyses, including *Global Monitoring Report 2004* and the recent Millennium Project and task force reports, which are more comprehensive. The chapter also contains an assessment of MDG-related global programs launched since 2000 and of the role donors need to play in accelerating MDG progress. It concludes with an action agenda for countries and their development partners derived from this stocktaking.

The Pace of MDG Progress, 2000–5

Five years after the global commitment was made to the MDGs, progress has been inadequate to ensure their attainment. Sub-Saharan Africa is

not on track to achieve a single MDG. In addition to the goals discussed in the following sections, it is off track on the hunger goal—and is the only region where child malnutrition is not declining. South Asia is off track on six goals: gender equality, universal primary school completion, child mortality, maternal mortality, communicable diseases, and sanitation. And while malnutrition in the region is dropping sufficiently to achieve the MDG target reduction, it remains at very high absolute levels: almost half of children under five are underweight. The Middle East and North Africa is also off track on six goals: gender equality, universal primary completion, child mortality, communicable diseases, water, and sanitation. Europe and Central Asia is off track on child mortality, maternal mortality, communicable diseases, and sanitation. And both Latin America and the Caribbean and East Asia and the Pacific are off track on child mortality, maternal mortality, and communicable diseases.

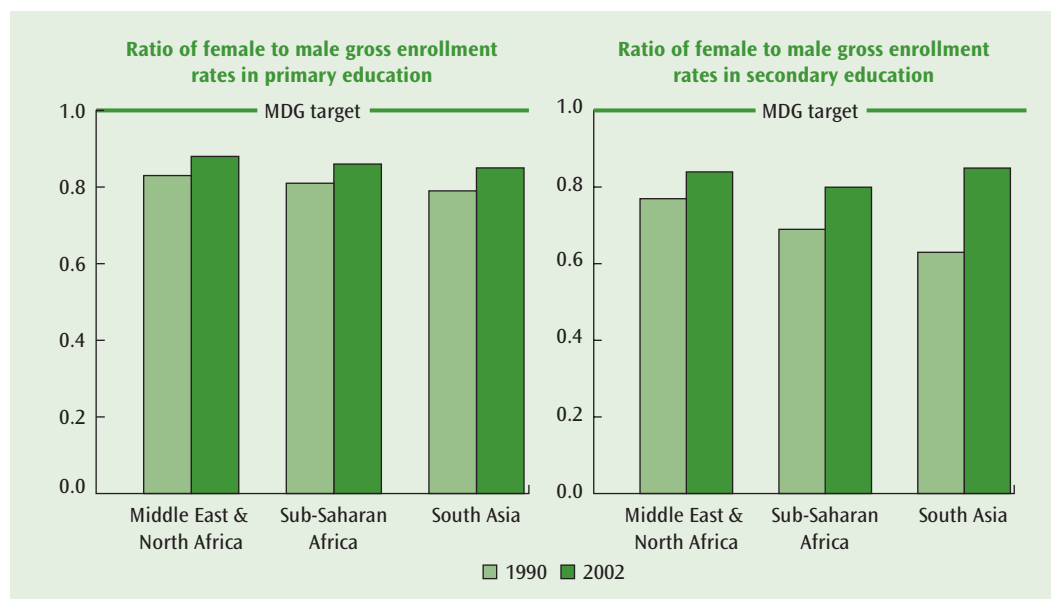
This slow progress is all the more troubling because the MDGs are only first-stage development goals; no 21st century country can afford to focus on these alone. No matter how far they are from universal primary comple-

tion, countries must simultaneously invest in secondary and tertiary education—both to produce the skilled workers that health, education, and other sectors need, and because increasing rates of primary completion generate social demand for more schooling. No matter how high child mortality is, countries must also address increased chronic diseases among adult populations. In a world of competing priorities and devastating natural disasters, the challenge facing developing countries is not just to achieve the MDGs; it is to achieve them at minimum global cost while simultaneously advancing other important goals. The following sections look at where progress is being made, where it is not, and why.

Gender Equality

The world will not achieve the first MDG target, set for 2005: gender equality in primary and secondary education. Despite strong progress in every region, girls' enrollments at the primary level are still less than 90 percent of boys' in Sub-Saharan Africa, South Asia, and the Middle East and North Africa (figure 3.1). At the secondary level, only Europe and

FIGURE 3.1 Despite progress, the 2005 gender target will not be met



Source: UNESCO Institute for Statistics.

Central Asia has achieved enrollment parity. Primary completion rates show the same pattern—great progress in narrowing the gap, but as of 2003 the completion rate for girls was still more than 15 percent below that of boys in Sub-Saharan Africa and South Asia. Forecasts for the 2015 goal of gender equality in tertiary education are even less encouraging, with less than 10 percent of developing countries on track to achieve this target.

Although gender parity in primary education will not be reached globally in 2005, an impressive number of countries will achieve it—even in the three regions with the deepest education inequality. In Sub-Saharan Africa these countries include Botswana, Gabon, The Gambia, Lesotho, Mauritania, Mauritius, Namibia, Rwanda, Seychelles, Tanzania, Uganda, and Zimbabwe; in South Asia, Maldives and Sri Lanka; and in the Middle East and North Africa, Jordan, Libya, Oman, and Saudi Arabia. Jordan and Oman have also achieved gender parity in secondary education.

While some of these countries had relatively equitable gender outcomes in education in 1990 (the year against which progress toward the MDGs is measured), in others policy actions and incentives have transformed the playing field for girls. In Guinea girls' enrollments in primary education rose from barely 40 percent of boys' in 1990 to a projected 88 percent in 2005. Similar progress has been made in Benin, The Gambia, and Mauritania, as well as Bangladesh, Morocco, Nepal, Papua New Guinea, and Yemen. How did they do it? Box 3.1 profiles different strategies.

But achieving gender equality and empowering women—the third MDG—require more than parity in education enrollments. Additional targets include attaining gender parity in literacy and increasing the share of women in nonagricultural employment and national parliaments. Although progress has been made, the gap has not closed in Sub-Saharan Africa, South Asia, and the Middle East and North Africa, where literacy rates among 15–24-year-olds are 10–20 percentage points lower for women than for men.

Paid employment is crucial to women's empowerment and important to families' welfare because women are more likely than men to invest their income in health care, education, and food.¹ But progress has been slow in this area. Between 1990 and 2003 women's share of nonagricultural employment in developing countries increased only 2 percentage points, from 35 percent to 37 percent.

More encouraging has been progress in political representation. The share of countries where women hold at least one-fifth of the seats in national parliaments grew from 13 percent in 1990 to 24 percent in 2004—a significant change. But as noted in a report prepared for the recent 10-year follow-up to the 1995 Beijing Conference on Women, the real mark of progress is women's greater prominence in political life translating into leadership positions and more influence over decision making. And in many cases, that has yet to happen.² Much remains to be implemented from the Beijing action plan, including faster progress on the gender equality targets reaffirmed in the MDGs.

The world's failure to meet the 2005 target for gender parity in primary and secondary education should not be rewarded with a reprieve to 2015. Most regions are on track to achieve parity sooner—particularly at the primary level, where girls' enrollments have been growing faster than boys' in every region. The United Nations should review the latest data and set a new year for this target, such as 2007 or 2008, to encourage the fastest possible progress.

Universal Primary Education

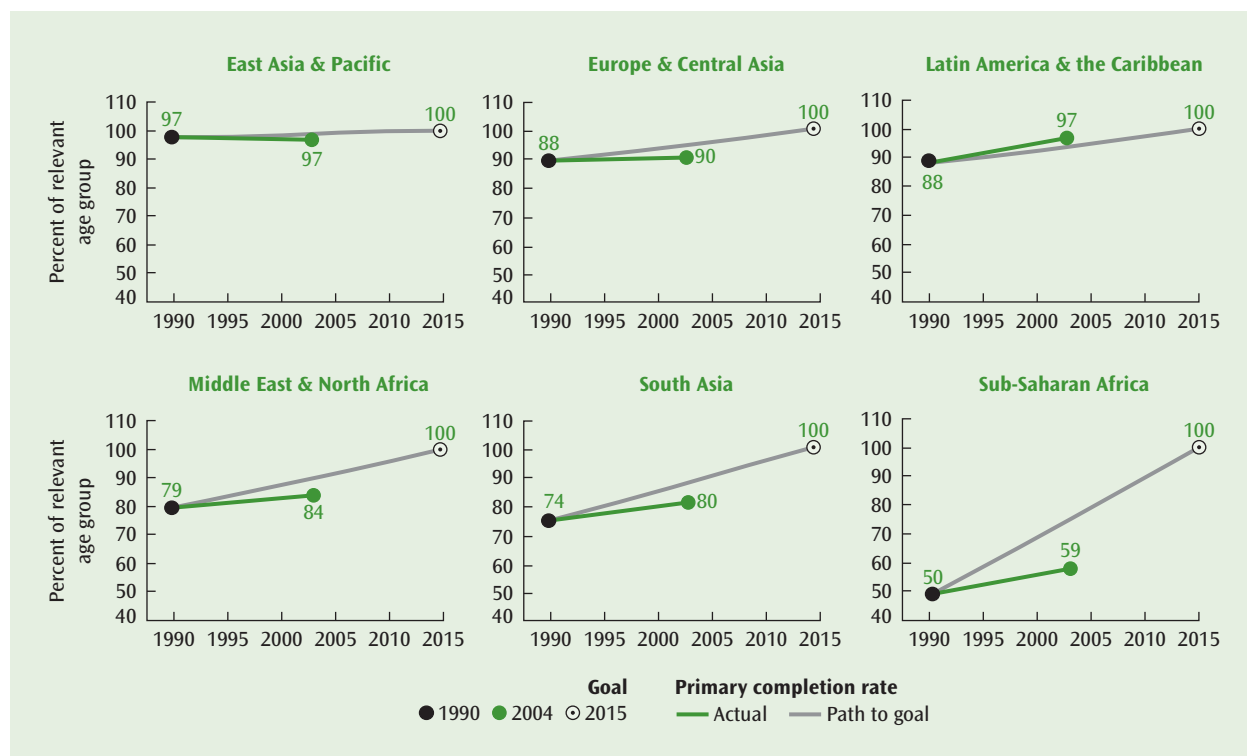
Primary education completion rates are increasing in all developing regions. But as with gender equality, in the Middle East and North Africa, South Asia, and especially Sub-Saharan Africa the pace of progress is too slow to ensure attainment of the second MDG: universal primary completion by 2015 (figure 3.2). Latin America and the Caribbean has made strong progress and, on a population-weighted basis, both it and East Asia and the Pacific are close to achieving the goal. In both regions, though, some smaller countries are not on track.

BOX 3.1 Sub-Saharan Africa shows that fast progress is possible in closing the gender gap

Twelve Sub-Saharan countries will meet the 2005 target of gender parity in primary education, and at least three others will come close. Many countries in other regions have also made exceptional progress in getting girls into school. In every case some combination of the following policies lies behind the progress:

- *Making schools affordable.* Eliminating school fees increases both girls' and boys' enrollments—but as shown in Tanzania and Uganda, these policies have a larger effect on girls. Countries such as Bangladesh and The Gambia have gone further, providing scholarships and financial aid for girls in the poorest communities. World Food Program "take-home rations" in Eritrea, Ethiopia, Ghana, Guinea, and many other African countries have also been associated with significant increases in girls' school attendance and completion.
- *Reducing the distance to school.* New schools often expand girls' enrollments faster than boys' because they relieve concerns about girls' safety in walking long distances to school.
- *Providing water and sanitation at schools.* In Bangladesh, India, Kenya, Nigeria, and other countries the introduction of clean, private sanitation and washing facilities in schools has raised girls' attendance rates by as much as 11 percent. UNICEF surveys in Africa and Asia show that in some countries as few as 10 percent of schools have adequate, separate sanitation facilities for boys and girls, and in some schools as many as 150 students share a single latrine. Standpipes at schools also ease the burden that girls face in fetching household water from distant sources.
- *Providing bilingual instruction.* Instructing children in their first language during the early years of schooling lowers repetition and raises attendance, classroom participation, exam scores, and promotion rates—especially for girls. In Mali teaching in the mother tongue in grade 1 and gradually replacing it with French afterward has led girls to volunteer more during class, read more comfortably, and stay in school. In Mauritania a switch to Arabic language instruction has increased girls' enrollments.
- *Increasing the number of female teachers.* In Botswana a consistently positive relationship has been found between the proportion of female teachers in a school and girls' achievement levels. The Gambia has reviewed curriculums to ensure that they are gender-sensitive and offers career counseling for girls.
- *Involving the community.* Involving communities in the development of national and local action plans helps identify and address factors that deter girls from attending school. In 1993 The Gambia became the first country to apply the Participatory Learning and Action approach to girls' education. Ideas that emerged included flexible fee payment schedules, separate latrines for girls and boys, and enforcement of sexual harassment policies in schools—and sharply increased girls' enrollments at both the primary and secondary levels. In Guinea, Kenya, Senegal, and Uganda this approach has led to changes in school calendars and fee policies, the creation of single-sex schools, and provision of community-supervised protection for girls.
- *Raising public awareness.* Niger's increase in girls' primary enrollments is partly due to campaigns on the importance of girls' education, particularly in rural areas. The Gambia has used women's theater groups to raise community awareness about the importance of girls' education.
- *Making schools girl-friendly.* Allowing married and pregnant adolescents to attend school and offering flexible school schedules has promoted girls' secondary school attendance in Botswana, Guinea, Kenya, Malawi, and Zambia.

Sources: IRC 2004; UNICEF Nigeria 2003; UNICEF India 2003 and other data; Sen 2000; UNICEF Somalia 1999.

FIGURE 3.2 Several regions are off track to achieve universal primary completion by 2015

Sources: UNESCO Institute for Statistics and World Bank joint database.
 Note: Data are weighted by population.

Although Europe and Central Asia needs to accelerate progress, the goal is within reach.

In the Middle East and North Africa, countries such as Morocco have made rapid progress, although primary completion rates in many of the large population countries in the region have been stagnating. In South Asia, reaching the education MDG will require faster overall progress: in India, where impressive performance in a number of states has not yet translated into aggregate national progress; in Pakistan, which remains seriously off track; and Afghanistan, which is recovering quickly, but from a tragically low base.

In Sub-Saharan Africa the overall prospects are dim. In 2003 only 59 percent of children completed primary school, and on current trends the region will not achieve universal primary completion until 2061.

Yet enormous education progress is being made in many Sub-Saharan countries. Annual

increases in primary completion in the region's best-performing countries far exceed anything achieved by today's developed countries when at a similar stage in their development.³ Since 1990, 8 of the developing world's 10 top performers have been in Africa: Benin, Eritrea, Ethiopia, Guinea, Mali, São Tomé and Príncipe, Togo, and Malawi. In all these countries primary completion rates have grown by more than 5.0 percent a year, well above the low-income country average of 0.8 percent. Core elements of policy progress in these and other countries have been political commitment to universalizing education, actions to lower the costs of expanding schooling through more efficient construction, teacher training, and hiring, attention to crucial inputs such as books and materials, and "demand side" adjustments to make schools more accessible—by adapting the language of instruction, changing school calendars, eliminating fees, and other actions.

For many countries the main challenge for attaining this MDG is the very low base from which they started. For any country with a primary completion rate below 60 percent in 2003, even the highest recorded rates of improvement (on a percentage point basis) would not be enough to attain the MDG. Around the world, 26 countries fall below that threshold—and 22 are in Sub-Saharan Africa.

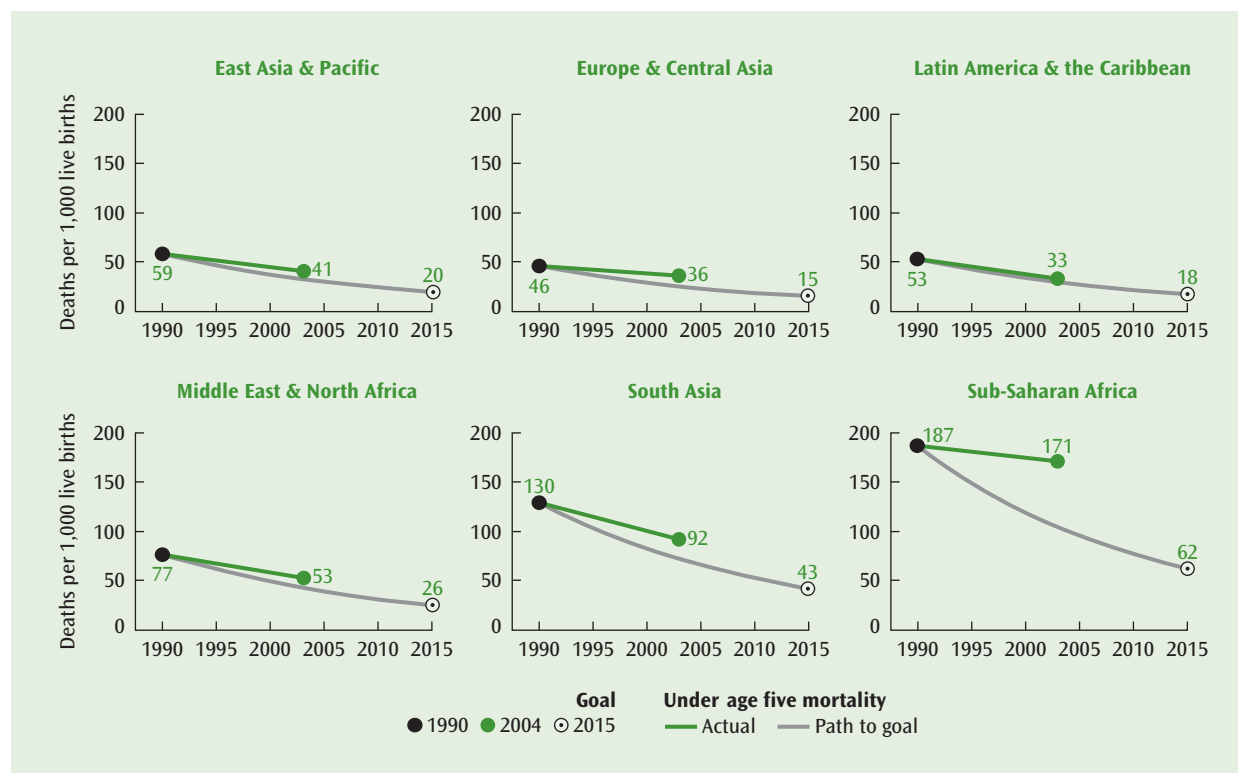
In another set of countries, though, slow progress is the issue. Between 1990 and 2000 the primary completion rate was stagnant in Ghana, Kenya, Nigeria, and Tanzania, and has only recently begun to increase. These countries can attain universal primary completion, but only if progress improves substantially and is sustained. That is also true for a significant number of countries in other regions, most notably India. There is clear scope for knowledge diffusion and increased

financing to help lagging countries, including through global programs such as the Education for All Fast Track Initiative. But global attainment of universal primary education by 2015 is far from assured.

Child Mortality

Every week in the developing world, 200,000 children under five die of disease—as many lives as were lost in the recent South Asian tsunami. The fourth MDG aims to reduce infant and under-five mortality by two-thirds between 1990 and 2015, implying an average reduction of 4.3 percent a year. Although no region achieved such a population-weighted reduction in the 1990s, Latin America and the Caribbean, the Middle East and North Africa, and East Asia and the Pacific are not far off track (figure 3.3).

FIGURE 3.3 Despite progress on child mortality, all regions are off track



Sources: UN and World Bank staff estimates.

Note: Data are weighted by population.

As with the primary completion rate, there is substantial variation in trends at the country level. Even in Sub-Saharan Africa, where little progress has been made overall, countries such as Ethiopia, Malawi, Mozambique, Namibia, and Uganda have improved child survival despite challenging circumstances, such as widespread HIV/AIDS (box 3.2). But other Sub-Saharan countries saw child mortality increase in the 1990s, erasing earlier progress.

About 70 percent of child mortality occurs in the first year of life, and almost 40 percent in the first month. Most of these deaths are due to five highly preventable and treatable conditions: acute respiratory infections, diarrhea, malaria, measles, and malnutrition. Basic post-natal care, breastfeeding, and access to simple, low-cost treatments for diarrheal diseases can have a major impact on infant mortality. Water supply and sanitation can also make a big difference: about 90 percent of diarrheal deaths among children are due to lack of safe water and sanitation.⁴ Finally, low-cost immunizations against measles, diphtheria, polio, and other diseases can prevent a lot of childhood sickness and death. Encouragingly, three developing regions have achieved 90 percent immunization coverage against measles: Europe and

Central Asia, the Middle East and North Africa, and Latin America and the Caribbean. But coverage has fallen in East Asia and the Pacific, and in Sub-Saharan Africa it has stagnated at less than 60 percent.

Maternal Mortality

Every week 10,000 women in the developing world die giving birth. A woman's risk of dying during delivery is 250 times higher in low-income than in developed countries. The fifth MDG calls for reducing the maternal mortality ratio by three-quarters between 1990 and 2015, an average annual reduction of 5.4 percent. Due to scarce data, maternal mortality is tracked largely through modeling projections from demographic data rather than direct reporting, and trend estimates are quite tentative. The World Bank estimates that only one developing region is on track to reach the maternal mortality target (Middle East and North Africa), though two others (East Asia and the Pacific, Europe and Central Asia) are close.⁵ In Latin America and the Caribbean the maternal mortality ratio (190 per 100,000 births) is lower than in other regions, but it is proving more difficult to achieve incremental improvements.

BOX 3.2 Reducing child mortality in Mozambique

Despite low economic development and high poverty—per capita gross national income (GNI) was \$200 in 2002, and 54 percent of the population lives below the poverty line—Mozambique has made impressive progress in lowering under-five mortality, from 226 per 1,000 live births in 1990 to 170 in 2003. While this level is still very high, the decline is encouraging given the country's unfavorable disease environment, with HIV/AIDS affecting an estimated 15 percent of adults and a high prevalence of malaria and other infectious childhood diseases.

What accounts for Mozambique's success? One important factor has been the country's efforts to provide basic preventive health services in remote areas, delivered by both community health facilities and mobile teams, resulting in high coverage for key interventions. About 85 percent of pregnant women receive antenatal care, while 77 percent of children are immunized against measles and 63 percent are fully immunized. Community-based services also promote healthy behaviors such as breastfeeding and oral rehydration therapy. Mozambique has shown that mobile teams can be effective in an environment with too few health facilities and a dire shortage of qualified health staff, reaching households that otherwise lack access to health care.

Source: World Bank 2004c.

Because measuring maternal mortality ratios directly is so difficult, the percentage of deliveries attended by medically skilled personnel is also used to track progress. Although this indicator increased in all regions between 1990 and 2000, it is still below 50 percent in South Asia and Sub-Saharan Africa.

HIV/AIDS, Malaria, and Other Diseases

The sixth MDG is to halt and begin reversing the spread of HIV/AIDS, malaria, and other major communicable diseases by 2015.

HIV/AIDS

Despite 20 years of efforts to control it, HIV/AIDS continues to spread. In 2004, 39 million people were living with HIV/AIDS (figure 3.4) and 3.1 million died—more than from any

other infectious disease. That same year nearly 5 million people became infected with HIV, 2 million children were living with it, and 15 million children had been orphaned by AIDS.

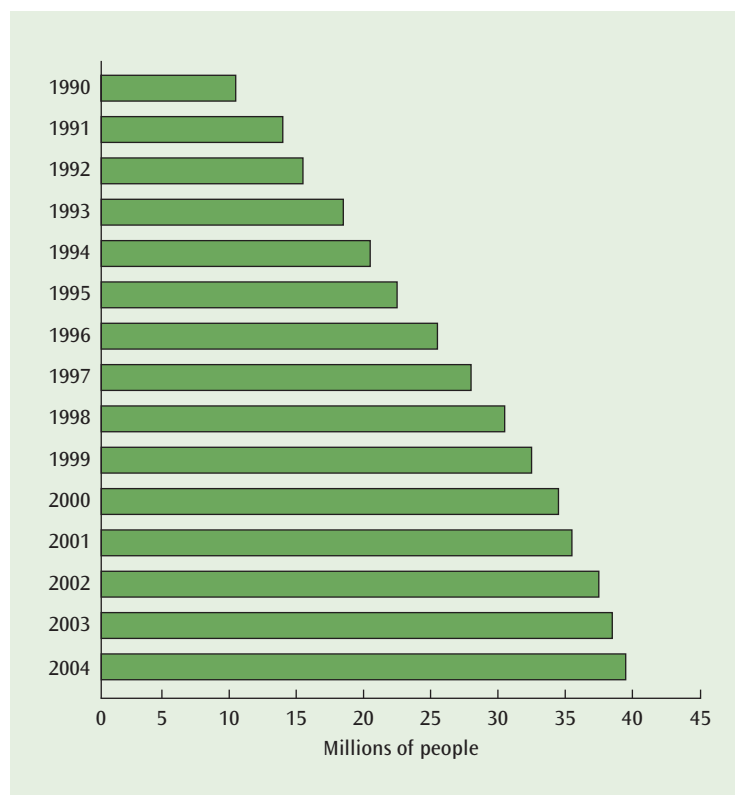
Sub-Saharan Africa remains by far the worst-affected region, home to nearly two-thirds of all people with HIV/AIDS. The average HIV prevalence rate in the region is 7.4 percent, or 1 in every 14 adults—and in parts of Southern Africa it is 1 in 3. In nine African countries life expectancy has dropped below 40 years because of the disease, and across the region 11 million children have been orphaned by it.

But HIV/AIDS poses enormous threats in every region. Since 2002 the number of people living with it has risen by 50 percent in East Asia, reflecting China's rapidly growing epidemic, and by 40 percent in Europe and Central Asia, driven by its rapid spread in the Russian Federation and Ukraine.

Two decades of battling HIV/AIDS have taught the world two main lessons. First, countries have a crucial window of opportunity early in the epidemic, when prevalence is largely confined to high-risk populations such as sex workers and intravenous drug users. Brazil, Cambodia, Senegal, and Thailand are among the countries that acted decisively to introduce strong prevention programs when prevalence was low, and they have achieved declining levels of new infections. Early action in Thailand averted an estimated 5 million infections during the 1990s.

Second, even in countries where HIV/AIDS has spread into the general population and the main mode of transmission is heterosexual, some are doing better than others at curbing its spread. Among African countries, in Uganda HIV prevalence among pregnant women dropped from 13 percent in the early 1990s to just under 5 percent in 2002, and in Botswana, Ethiopia, and Kenya the prevalence in urban populations appears to have stabilized.⁶ The key has been forthright national leadership, widespread public awareness campaigns, and intensive prevention efforts.

FIGURE 3.4 Since 1990 the number of people living with HIV/AIDS has quadrupled



Source: UNAIDS data.

Yet these lessons appear unheeded in many countries, including large countries such as China, India, and the Russian Federation. Unless more aggressive actions are taken in these and other countries, HIV prevalence is projected to rise further. Work continues on vaccine development, and the Joint United Nations Programme on HIV/AIDS (UNAIDS) estimates that the number of people with access to antiretroviral drugs increased from 300,000 in 2002 to 700,000 in 2004. But given that the impact of expanded treatment on HIV transmission is not clear, it is crucial to redouble education and prevention efforts at the same time.

Financing, research, and global advocacy for HIV/AIDS have increased significantly since the MDGs were adopted. Commitments for HIV/AIDS prevention and treatment programs jumped from less than \$400 million in the late 1990s to an estimated \$6 billion in 2005. Now concerns have shifted from financing to implementation, reflecting the multiple donor procedures for accessing support and weaknesses in health delivery systems. Faster progress is needed in harmonizing donor aid at the country level and implementing the “three ones” principle agreed to in mid-2004: that all donors will work through one HIV/AIDS coordinating agency in each country, one national strategic plan, and one system for monitoring and evaluating progress.

MALARIA

Malaria takes a heavy toll on health and economic productivity where it is endemic, and it is concentrated in countries that can least afford it: 69 of the 80 poorest countries have endemic malaria. Data are poor because many cases go unreported, but the annual incidence of malaria is estimated at 300–500 million cases—with 1.2 million deaths, mainly among children. About 85 percent of these deaths occur in Africa, 8 percent in Southeast Asia, 5 percent in the Eastern Mediterranean, 1 percent in the Western Pacific, and 0.1 percent in the Americas. In many African countries malaria is the leading cause of death.

Yet malaria is eminently preventable, curable, and controllable with modern technologies—at a cost of a few dollars per person. Brazil’s malaria control program is credited with averting an estimated 2 million cases and 231,000 deaths. Other countries that have made impressive progress include Eritrea (which has reduced malaria incidence over four consecutive years through the use of insecticide-treated bednets), India (which since 2002 has reduced malaria incidence by 58–98 percent across different states), and Vietnam.

Effective strategies generally involve a combination of vector control, insecticide-treated bednets and curtains, indoor residual (house) spraying with insecticides where the pattern of transmission warrants it, intermittent preventive treatment during pregnancy, and prompt treatment of infections with effective drugs. Global funding for malaria has almost quintupled in the past few years, from \$120 million to \$570 million, thanks largely to the Global Fund to Fight AIDS, Tuberculosis and Malaria. Yet most experts estimate that as much as \$1 billion more a year is needed. Bednet use remains low in many malarious countries, vector control is inadequate, and increased resistance to traditional drugs is requiring newer, more expensive treatments. But experience shows that rapid gains can be made against malaria, even in countries with weak health systems. The Roll Back Malaria effort provides a global framework for intensified progress.

Water and Sanitation

Expanding water and sanitation services is one of the most cost-effective strategies for improving health outcomes. Water and sanitation coverage also makes powerful contributions to other MDGs, including achieving gender equality and reducing poverty and malnutrition. The seventh MDG seeks to halve by 2015 both the proportion of people without sustainable access to safe water and the proportion

without adequate sanitation. Achieving both targets would provide safe water to another 1.5 billion people and sanitation to another 2.0 billion people. Unsafe water and poor sanitation and hygiene are responsible for 90 percent of diarrheal diseases and an estimated 4–8 percent of the total disease burden in developing countries.⁷

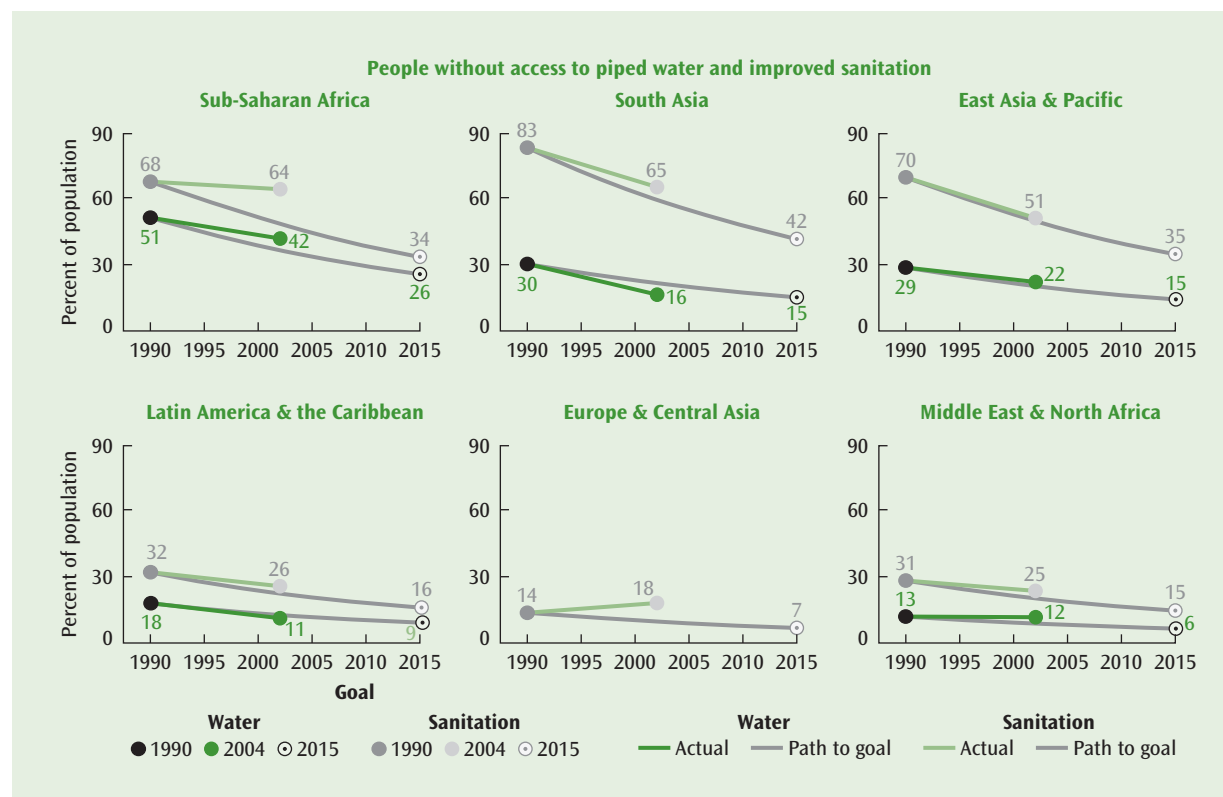
The most recent estimates by the World Health Organization and United Nations Children's Fund indicate that most developing regions are on track to achieve the safe water target (figure 3.5). The exception is Sub-Saharan Africa, where only slightly more than half of the population has access to safe water. To achieve the water target in Sub-Saharan Africa, for each of the next 10 years the number of additional people served would have to double for urban water and triple for rural water. Only a handful of coun-

tries in any region have achieved such progress, particularly in rural areas. But Ghana, Senegal, South Africa, and Uganda have shown that it can be done.

The sanitation target is more problematic, with only two regions on track—East Asia and the Pacific and Latin America and the Caribbean. At current trends, the world will miss the sanitation target by more than half a billion people. But even within lagging regions some countries have made significant progress. Between 1990 and 2002 Bangladesh, India, and Nepal more than doubled sanitation coverage, with some notable successes in slums (box 3.3). In Africa strong progress has been made by Cameroon, South Africa, and Uganda. And within countries there are local success stories, as in Burkina Faso and Senegal.

The keys are sustainable institutions financed through effective cost recovery of

FIGURE 3.5 Progress is being made in water supply, especially in South Asia, but sanitation progress is slower



Source: WHO and UNICEF joint monitoring program.

Note: Only sanitation estimates are available for Europe and Central Asia.

BOX 3.3 Improving sanitation in India's slums

The crowded slums of Mumbai (formerly Bombay), India, are home to 7 million people. Recognizing their needs, an innovative sanitation program financed by the World Bank has built 320 toilet centers that serve 500,000 slum residents. These community-managed centers provide sanitary excreta disposal (with continuous water supply, to ensure hygiene), offer health education, and are gradually replacing municipally managed latrines that were rapidly falling into disuse. Although the toilet centers were financed by grants, user families pay monthly subscriptions that cover the running costs, including wages of attendants. All the toilet centers have been well maintained and are the pride of the communities that own them. The success of similar community-run programs in other Indian cities has led to the adoption of a nationwide slum sanitation program that will apply the same principles.

Source: OED 2003.

sanitation surcharges linked to water bills, greater use of demand-based onsite sanitation technologies, and increased reliance on small-scale local contractors and artisans as sanitation service providers. A shift in focus to onsite sanitation, which is much cheaper than piped sewerage, is helping increasing numbers of low-income countries speed MDG progress. In Dakar, Senegal, for example, onsite sanitation has permitted service delivery to hundreds of thousands of periurban slum residents for the first time. The investment cost was about \$400 a household, and residents can afford the operating costs.

Is MDG Progress Reaching Poor People?

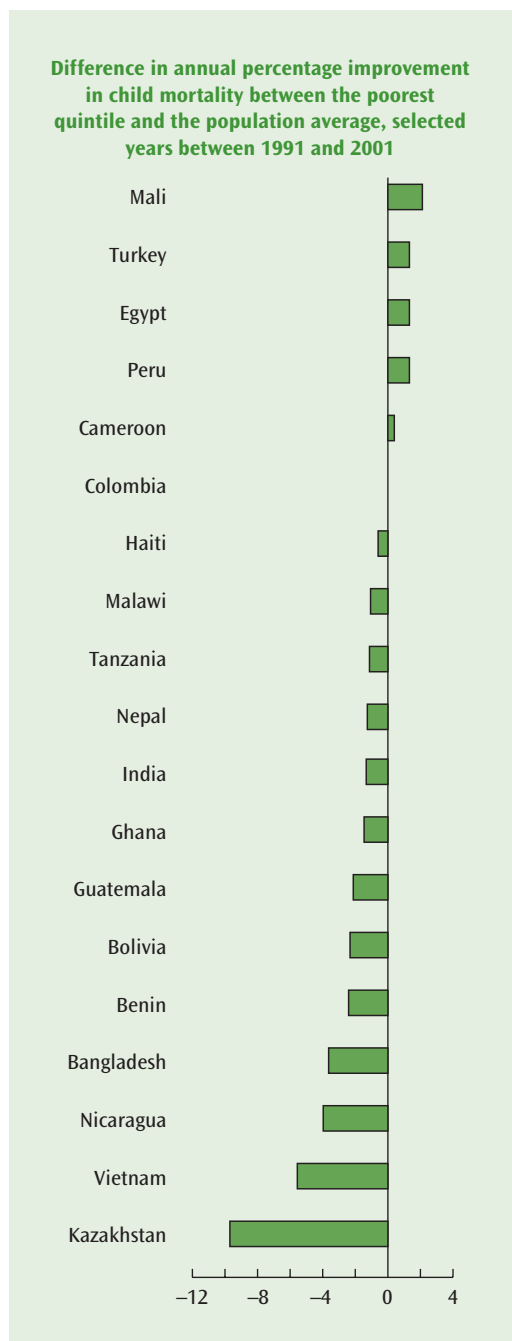
The MDGs aim to improve human welfare. But it is important to recognize that some of the goals—especially in health—can be achieved without progress reaching poor people. In two-thirds of the countries that have reduced child mortality since 1990, outcomes for families in the lowest income quintile have improved less than for the population as a whole (figure 3.6). In some of these countries outcomes have actually worsened for the poor while improving for richer groups.

It is crucial to learn from the exceptions. During the 1990s Mali, Turkey, Egypt, Peru, and Cameroon achieved faster reductions in child mortality for the poorest quintile than for the population as a whole.

Because improvements in health outcomes for the poorest groups will not automatically result from the pursuit of MDG health goals, policymakers must focus on targeted strategies for reaching poor households. In many settings effective targeting must take into account other characteristics of disadvantaged groups, such as ethnicity or rural residency. Effective strategies for reaching target groups include prioritizing the expansion of services in poor or rural regions, expanding those services (such as basic water and sanitation, primary health care, and primary education) that most benefit poor people, and eliminating user fees in primary education and for essential health services for poor families, since such fees can impede their access to services.

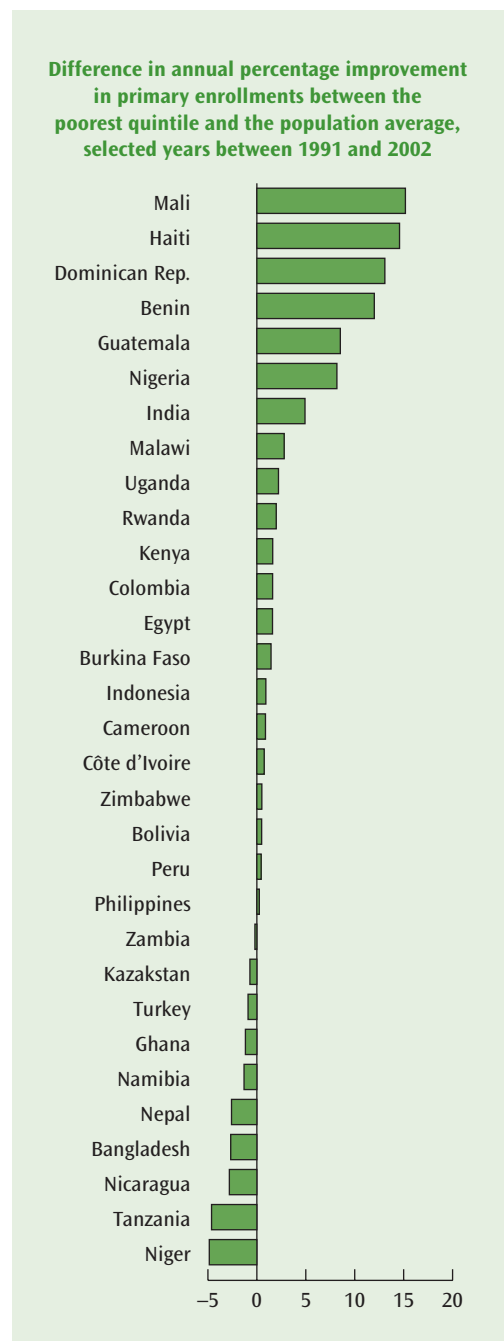
In education, progress toward universal primary completion more often enhances equity. In 21 of 31 developing countries for which comparable survey data are available between 1991 and 2002, primary enrollments for children in the bottom income quintile increased faster (in two cases, declined less) than enrollments for the population as a whole (figure 3.7). This finding is confirmed by more detailed studies in countries such as India, showing that expansion of basic education has been progressive in impact—that is, it has benefited lower-income groups more than other groups.⁸ Still, in about 30 percent of countries primary enrollments for children

FIGURE 3.6 Progress on health does not always benefit poor people



Sources: World Bank estimates from Demographic and Health Survey data.

FIGURE 3.7 Progress on education is generally more equitable



Source: World Bank estimates from Demographic and Health Survey data.

from upper-income groups increased more than those for the poorest children. As policymakers and development partners track national progress toward the MDGs, it is essential to watch the progress of the poor.

In education, health, water, and sanitation many of the interventions needed for better outcomes in developing countries are well understood. The International Water Supply and Sanitation Decade of the 1980s showed that scaling up investment is not difficult—far more challenging is ensuring the sustainability of systems, which is crucial for safe and continuous services. Building schools and health clinics is far less complex than developing and organizing the large workforces of skilled providers that must engage in face-to-face interactions with individual clients across highly decentralized networks. For most countries the two main implementation challenges to the health and education MDGs are scaling up skilled providers to achieve universal access to services and ensuring that providers perform effectively. The rest of this chapter focuses on these two issues and on a third with important links to both: the role of donor financing in supporting system expansion and leveraging better performance.

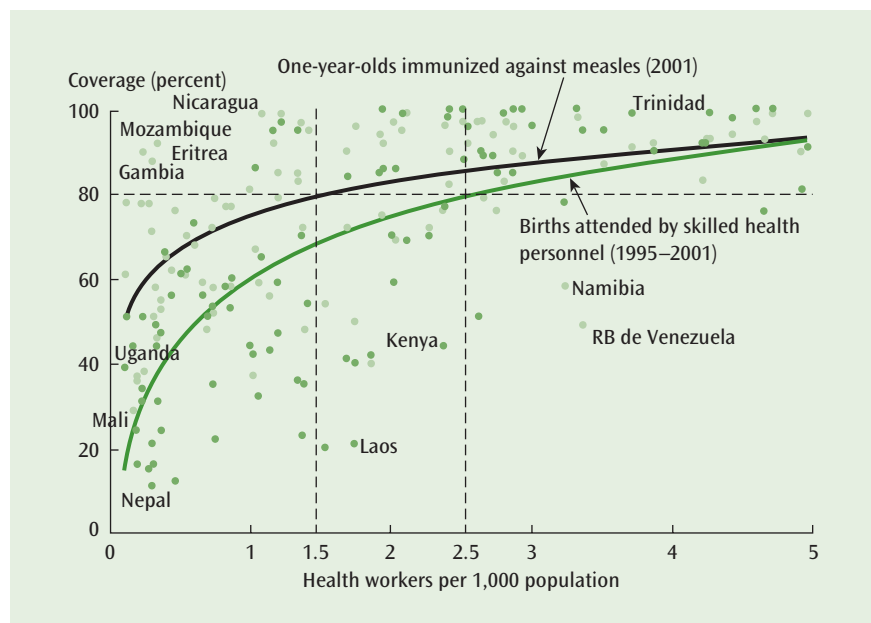
Scaling Up Skilled Providers

Student learning and patient health result from multiple complementary inputs, including school and clinic infrastructure, availability of books, drugs, and clean water, and family investments of time and energy, to study for exams or follow treatment instructions. But skilled providers—teachers, doctors, nurses—are the biggest expense in any social sector budget, as well as the most essential input for effective service delivery. Teacher costs average 75 percent of total edu-

cation costs in developing countries, and health care salaries typically account for 60–75 percent of government health spending.⁹ Policies governing the recruitment, training, salaries, deployment, and management of skilled education and health workers are core drivers of system costs, unit costs, resources available for complementary inputs, and outcomes.

Although there is considerable variation across countries, the number of health care providers is correlated with health service coverage. Countries with fewer than 1.5 health workers per 1,000 people are highly unlikely to have a measles immunization rate of 80 percent, whereas this rate is almost assured in countries with a health worker density of more than 2.5 (figure 3.8).¹⁰ Countries with fewer than 2.5 health workers per 1,000 people are also less likely to have at least 80 percent of births attended by skilled personnel. In education the process of classroom instruction creates even tighter limits on the number of children that can receive “education services” for a given number of teachers. No country with less than 1 teacher per 70 school-age children has achieved universal primary enrollment.

FIGURE 3.8 Health service coverage increases with the number of providers



Source: Joint Learning Initiative 2004.

FIGURE 3.9 Provider presence is also associated with better health outcomes



Source: Calculations based on Anand and Barnighausen 2004.

The number of skilled providers is also important for health outcomes. A recent study of 83 countries found that a 10 percent increase in the number of trained health workers (doctors, nurses, midwives) per population unit is associated with a 2–5 percent decline in mortality, controlling for per capita income, poverty, and female literacy (figure 3.9).¹¹ Maternal mortality outcomes are the most sensitive to provider density, because skilled health workers can address a larger share of the conditions that lead to maternal mortality than the conditions that lead to infant or child mortality.

Although worker numbers are important, skill levels are key. In a rigorous study of primary education in the United States that controlled for students' innate ability and socioeconomic status, the teacher a child was assigned could affect his or her learning levels that school year by up to a full grade—a huge difference that dwarfs any other factor correlated with learning, such as books, facilities, class size, or teacher salaries.¹² And, important for policymakers, these large differences in teacher effectiveness were not well correlated with the formal measures usually believed to determine teacher quality, such as

their level of education or years of experience. What counted was what teachers actually know and can do.

A recent large-scale learning assessment in Vietnam confirms this finding. The strongest predictor of students' performance on fifth-grade tests of reading comprehension and mathematics was their teachers' performance on the same tests. Not the teachers' salaries, training levels, or teaching conditions—but their mastery of the subjects being taught. A sobering finding was that the bottom 30 percent of teachers actually scored lower on reading comprehension than did the top 12 percent of fifth grade students.¹³ Few developing countries have braved political pressures to measure teachers' subject knowledge directly, but those that have—including Brazil and Peru—have also found teachers' mastery of content to be a critical determinant of education quality.

Research also demonstrates the importance of provider quality in health. In 1992 Indonesian health centers were forced to cut incentive payments for rural doctors as part of a government effort to reduce the fiscal deficit. As a result, over the next several years there was a 30 percent decline in the average number of physicians per rural health center (from 1.8 to 1.2). Although patient visits were not affected, the quality of care was—and there was a 39 percent increase in child stunting in the affected regions.¹⁴ Such severe malnutrition is likely to have long-term cognitive and productivity effects on the children involved and may generate cumulative economic costs that outweigh the short-term fiscal savings from the reforms.

Interestingly, the researchers in Indonesia evaluated providers not with formal measures such as level of education, but by observing how closely they followed best practices in diagnosing and treating patient conditions. The conclusion: As in the education research, what providers know and can do are crucial to quality services. Whether scaling up systems through new hiring or trying to improve existing education and health services, the most effective governments focus on screening and rewarding candidates for

competency, and avoid recruitment and advancement driven by clientelism, formal qualifications, or years of service alone.

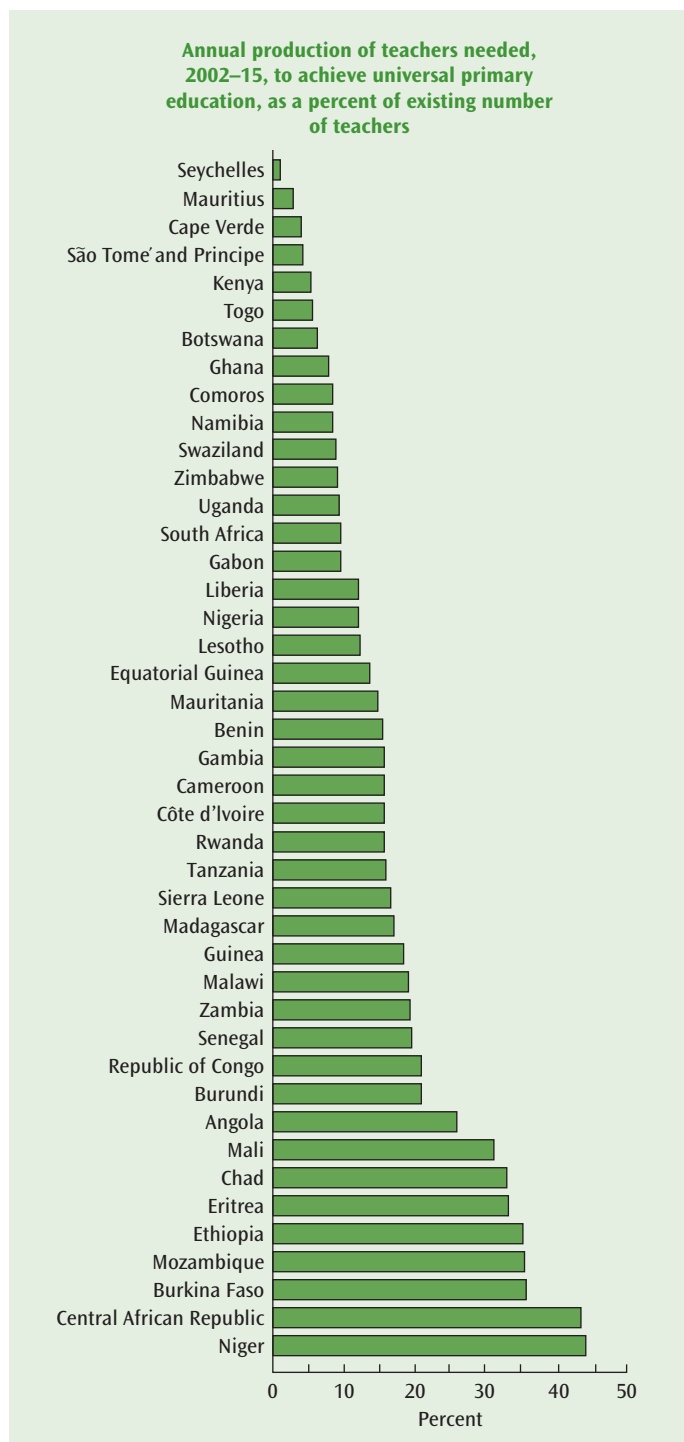
Are Human Resources a Binding Constraint?

The low-income countries furthest from the MDGs, many of which are in Sub-Saharan Africa, face major challenges in producing the number of skilled providers required to deliver the health and education services needed to attain the MDGs—even under optimistic assumptions about the impact of service delivery on outcomes. The Joint Learning Initiative, supported by the Rockefeller Foundation, the World Health Organization, and other health donors, estimates that for Sub-Saharan Africa to rise from its current ratio of 1 health worker per 1,000 people to a target level of 2.5, the region will need to add the equivalent of 1 million health workers between now and 2015.¹⁵ Ethiopia will require an additional 150,000 workers, while the Democratic Republic of Congo and Nigeria will each need 90,000. Globally, about 4 million additional health workers will be needed, including 285,000 in Bangladesh.

Estimates of teacher requirements are also daunting, especially for Sub-Saharan Africa. To meet the needs for primary education alone, eight Sub-Saharan countries must produce at least 30 percent of their current stock of teachers each year until 2015 (figure 3.10). Two countries need to annually produce more than 40 percent of their current stock. In some countries annual requirements are more than 10 times current output from teacher training schools (figure 3.11).

Clearly, in much of Sub-Saharan Africa the MDGs will not be attained with “business as usual” approaches to the production of skilled health workers and teachers. But in a growing number of countries, pragmatic changes in human resource policies have dramatically increased the number of skilled providers. Although not all cases have been equally successful in terms of provider and service quality, they demonstrate a range of

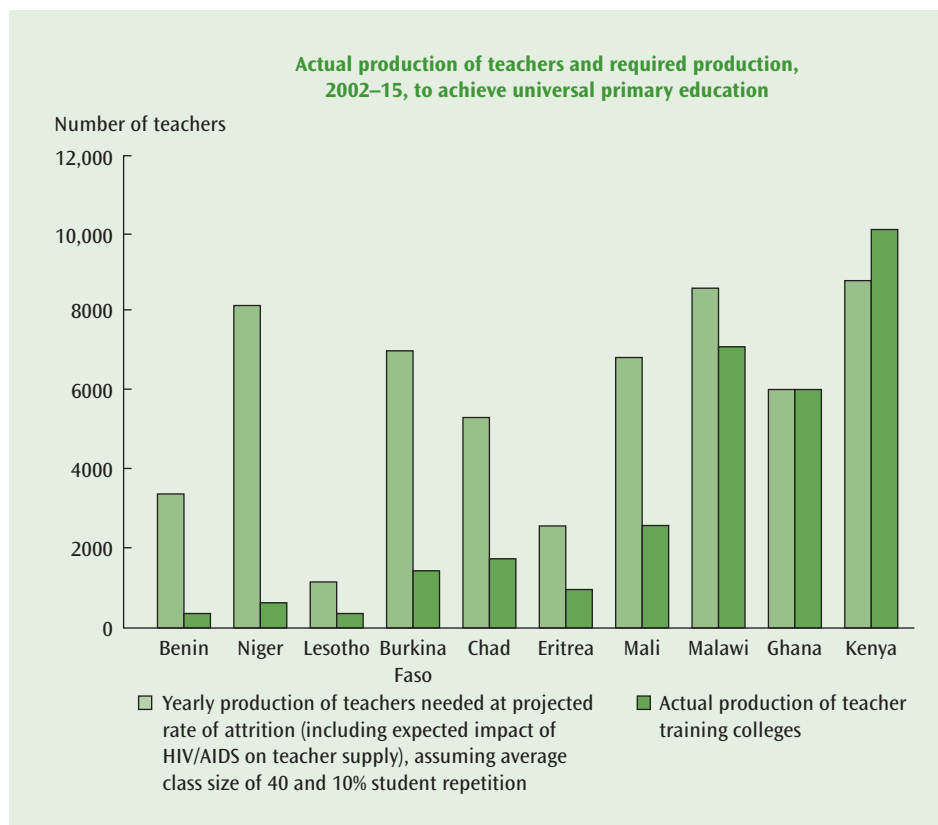
FIGURE 3.10 Projected primary teacher needs are large in Sub-Saharan Africa



Source: Calculated from EdStats data.

Note: Projected from 2001 data.

FIGURE 3.11 Projected primary teacher needs far exceed training capacity in many African countries



Source: Calculated from EdStats data.

Note: Projected from 2001 data.

strategies for rapidly shifting the production curve for skilled providers. In several cases sector efficiency has also improved, because new recruitment strategies have lowered costs per beneficiary served. And a few cases show that rapid expansion of quantity can be managed with attention to quality.

Core Strategies for Scaling Up Providers

Three basic strategies can be used to rapidly increase a country's production of education and health workers:

- Expand training capacity and/or adapt recruitment standards and training processes.
- Manage international migration, either by importing skilled workers or curbing outflows of nationally trained workers.
- Increase retention, by drawing retired or unemployed workers back into the workforce or by improving the health of sick workers, such as with antiretroviral treatment for employees with HIV/AIDS.

The first of these strategies has generated the most dramatic progress: In a wide range of countries, adapted standards and reengineered training processes for teachers and health workers have set the stage for rapid expansion of service delivery. The second strategy applies much more to health than to education, given the international market for health workers.

The third strategy, while important, offers limited quantitative prospects in most contexts.

ADAPTING RECRUITMENT STANDARDS AND TRAINING PROCESSES

The time lag and costs involved in expanding traditional medical, nursing, and teacher training schools have led a number of developing countries to seek alternative ways of scaling up basic health and education personnel. In education the most common approach is to set new standards for teaching that do not require graduation from a pedagogical institute—even though in some cases more years of general education may be required. In health, waiving or shortening medical schooling for doctors is generally unacceptable, so the main strategy is to leverage available doctors and nurses better with paraprofessionals. These paraprofessionals—often called community health workers—are trained for periods ranging from three months to two years and can provide many primary and preventive health care services. In countries with severe shortages of higher-skilled professionals they may even perform duties normally performed by physicians, as China’s “barefoot doctors” did in the 1960s.¹⁶ An important advantage of community health workers—and of alternative or community teachers—is that they are willing to work in rural areas, where it can be difficult to attract highly trained personnel. Community health workers are also less likely to migrate out of the country.¹⁷

Bangladesh, China, Cuba, The Gambia, Ghana, India, Madagascar, Mozambique, and South Africa are among the many countries that have trained community health workers to scale up delivery for a wide range of services, including malaria prevention, immunizations, family planning, tuberculosis treatment, and home visits to provide neonatal care. In many cases these efforts have substantially increased coverage, generated measurable improvements in outcomes, and dramatically lowered unit costs. In rural Maharashtra, India, infant mortality was cut in half—from 76 to 39 per 1,000 live births—between 1995 and 1998 by a program that trained village health workers to visit

new mothers and monitor infants’ weight and health for the first month of life. In control villages infant mortality declined only from 77 to 75 per 1,000 live births.¹⁸

Since 1991 South African tuberculosis patients treated by community health workers have actually achieved better health outcomes than those treated by more skilled personnel; 88 percent of patients seen by community health workers completed the full course of treatment, compared with 79 percent of patients seen by fully trained doctors and nurses. As a result the directly observed treatment strategy (DOTS) for tuberculosis implemented by community health workers was as effective as hospitalization or sanatorium care—at less than half the cost.¹⁹

The Planned Parenthood Association of Ghana trained community members to provide health education and family planning support to women in their communities. In villages covered by the program, family planning use reached 25–44 percent, far higher than the rural average. Immunization rates were 74–87 percent, compared with 30 percent in control villages. Moreover, village women who received support promoted maternal and child health and family planning in neighboring villages. The results point to a low-cost strategy for improving maternal and child health.²⁰

Drawing on these experiences and the evidence on cost-effectiveness, several African countries are rapidly scaling up training of paraprofessional health cadres. Over the next five years, for example, Ethiopia plans to train 20,000 health extension workers to staff rural health posts throughout the country.²¹ However, not all country efforts to realign the skills mix in health have been evaluated carefully, and clearly not all skills can be substituted. A significant number of programs—particularly those where paraprofessionals have not been paid or supported with basic equipment, drugs, and backup—have been unsuccessful.²² But with adequate supervision, reasonable remuneration, and simple support systems, there is great potential for community health workers to help expand service delivery at basic levels of quality.²³ Medical schools are

rare in Sub-Saharan Africa, with 6 countries having none and 21 having just one.²⁴ For countries such as these, at least over the short to medium term—as production of doctors and nurses expands—there appears to be little alternative but to leverage the skills of fully trained professionals with judicious use of community health workers.

In education a number of countries have shown the potential for alternative teachers to help accelerate expansion of primary schooling. Even countries where the annual production of teacher training institutes is small often have large pools of unemployed university graduates who can be recruited into teaching. In West Africa this strategy has led not only to a large increase in primary enrollments over the past decade, but also to rising average levels of teacher education. Guinea—which over the past decade has achieved one of the world's most impressive increases in primary school completion—is a good example.

In 1998, under a project supported by the World Bank, Guinea experimented with two alternative changes in recruitment standards for primary teachers. Under one variant pre-service teacher training was shortened from two years to a staggered program involving three months of initial training, eight to nine months of on-the-job training, and a final three months of formal training. The second variant involved eight months of formal training followed by eight to nine months on the job. For both alternatives the pre-training education requirement was increased from grade 10 to grade 13 (grade 12 for women).

The two new programs enabled Guinea to increase annual teacher production from 200 to 2,000 a year—a 10-fold increase that has had a similar impact on enrollment growth. Moreover, the benefits were not all quantitative: Controlling for socioeconomic and school factors, students of the new teachers performed better than those of traditional teachers on a recent study of learning achievement in francophone countries.²⁵ Guinea's experience suggests that adjusting teacher recruitment standards to emphasize content

mastery (through a higher level of general education), and complementing this with relatively short-term training focused on practical classroom techniques, can be more efficient than expanding traditional teacher training institutes.

A similarly pragmatic strategy enabled Madhya Pradesh, India, to eliminate its backlog of children out of school in just 18 months, at one-third the usual cost.²⁶ The state reduced the education level required to teach in rural schools and gave villages funding to directly hire local secondary school graduates. These changes eased constraints on teacher supply and permitted rapid expansion of access; in 1997 the state opened 40 new primary schools a day. A key similarity with the Guinean program was the emphasis placed on supporting these new teachers in service, with materials and regular supervision, as a cost-effective alternative to formal pre-service training.

These two examples—and similar earlier reforms in countries ranging from the Republic of Korea in the 1950s to Indonesia in the 1970s and Zimbabwe in the 1980s—demonstrate that with pragmatic strategies to adapt recruitment standards and restructure training, teacher production can be scaled up 10-fold or more in just one or two years. In recent years virtually all countries with very low primary completion rates have begun pursuing such policies, and in none has the supply of potential teachers been a constraint. On the contrary, even when offering average salaries as low as half the civil service teacher wage, countries have found more qualified applicants for contract teaching positions than they can afford to hire. In Benin, where the national training institute produces only 100 teachers a year, 6,500 university graduates recently applied for 1,000 new contract positions. In Senegal, which in 1998 became the first West African country to introduce contract teachers, there were 35,000 applicants for the first 6,000 positions. In Niger teacher production has quadrupled since 2001, when teacher training was shortened from two years to one and contract teachers

were introduced. The experience has been the same in Ethiopia, Mali, Togo, and elsewhere.

Do the adapted standards affect quality? While more research is needed, the best answer at present is that the results have been mixed. In many countries the adoption of new standards has been driven as much by fiscal constraints on hiring teachers at prevailing civil service standards and wage scales as by an absolute shortage of skilled (or skillable) personnel. Alternative teachers are often hired under new contracting arrangements that provide less job security and, in many cases, a direct role for communities in creating contracts and monitoring performance. These multiple variables can make it difficult to disentangle whether changes in teacher behavior and student learning outcomes reflect differences in teacher skills or differences in motivation. In contrast to the results from Guinea, a study of fifth graders in Togo showed slightly lower learning by students of contract teachers, controlling for other factors.²⁷ But it is important to remember that in most cases—and especially for poor children in rural areas—the alternative to contract teachers is not a formally trained civil service teacher, but no schooling at all.

Changes in teacher contracting and the training of paraprofessional health workers have met resistance from labor unions. Indeed, one of the most difficult aspects of launching such reforms may be the political economy of maintaining two-tier salary systems over time. African teacher unions have been vocal critics of the use of contract teachers and are trying to organize these workers to demand higher salaries.

But the magnitude of human resource shortfalls in these sectors leaves governments committed to universalizing education and basic health coverage—committed, that is, to achieving MDG targets—little choice but to make these pragmatic adjustments, evaluate them carefully, and upgrade provider quality over time. It is encouraging that the long-term evidence in education suggests that, controlling for country income, countries that achieve universal coverage sooner, even by

adapting teacher standards, achieve higher average levels of student learning.²⁸ The keys to success are likely to be countries' ability to screen new candidates carefully, train them effectively, equip them adequately with well-designed teaching manuals and treatment protocols, provide ongoing, cost-effective, in-service support and supervision, monitor and reward performance effectively, and gradually raise standards over time. In education that has been exactly the approach taken over a 40-year span by countries, such as the Republic of Korea and Singapore, that have made the transition from low-income status and low average education levels to sustained economic growth and high-performing education systems.

MANAGING MIGRATION

A confounding issue for developing countries trying to scale up health services is the globalization of the health care workforce, as migration flows increase throughout the world. While the national specificity of a curriculum makes teacher migration relatively rare, the past decade has seen an explosion in the migration of physicians and nurses from developing to developed countries.²⁹

Such outflows have reached troubling levels in several developing countries, when compared with the size of the health workforce and the output of local training institutions. There are allegedly more Nigerian doctors in the New York (United States) area than in Nigeria, and more Malawian doctors in Manchester (United Kingdom) than in Malawi. Of the more than 600 physicians trained in Zambia since its independence, only 50 remain in the nation's health system. Of the 489 students who graduated from the Ghana Medical School between 1986 and 1995, 61 percent have left Ghana—with more than half going to the United Kingdom, and just over a third to the United States.³⁰ A third of Ethiopia's physicians left the country between 1988 and 2001. And in 2003, 7 percent of Zimbabwe's public sector nursing force migrated to the United Kingdom alone.

While migration brings significant benefits in terms of remittances, networks, and technology transfers, for most Sub-Saharan countries it also creates a loss of skills that the region can ill afford. There are relatively few countries in the region where the labor market cannot fully absorb graduates of medical training programs. In Malawi, for example, vacancy rates for funded positions in the public health system are 25 percent for nurses and as high as 80 percent for specialists, and in Zambia, 40 percent of funded public sector health positions are vacant. Yet, at the same time, in both countries skilled providers are leaving the public system. The key constraint on the use of available funding appears to be the public sector's inability to selectively increase wages in health to more competitive levels without creating broader civil service wage pressures.

The pull from developed countries is expected to grow. In the United States an estimated 126,000 nursing positions are unfilled, and the shortage is projected to hit 500,000 by 2015. The United Kingdom will require an additional 35,000 nurses by 2008.³¹ Given the enormous compensation differences between developing and developed countries, what can developing countries do to manage migration?

Policies currently being tried include bonding, mandatory community service, diaspora exchange programs, and ethical recruitment guidelines, such as the Commonwealth Code of Practice adopted in 1999 in the United Kingdom. While the general consensus is that these efforts have had little impact,³² Thailand has had some success in attracting back medical professionals. The government's "reverse brain drain" strategy has involved relaxing licensing requirements and offering generous research funding and monetary incentives.³³ A few other countries, most notably Ghana, are trying reverse migration strategies; in the early 1990s they began recruiting Cuban doctors and senior allied health professionals. The number of Cuban doctors recruited to Ghana increased from about 60 a year in the early 1990s to more than 200 a year in

2003. The doctors provide services, mainly in rural areas, for two years.³⁴

There is no simple solution, and actions are needed by both developed and developing countries. Donor countries can help by trying to attract more of their own citizens into nursing, for example, by raising wages; the British government recently did this. Donors can also help finance the expansion of medical training in developing countries, recognizing that some share of graduates will inevitably migrate. Developing countries need to keep salaries in public health systems as competitive as possible, and donor countries can help finance salary increases through development assistance. Finally, developing countries can make medical and nursing students finance their studies with loans and, if a student migrates before the loan is repaid, work with the receiving country to recoup the balance through that country's tax system.

INCREASING RETENTION

To boost human resources, several countries have explored recruiting retired, inactive, or unemployed workers back into the labor force and in some cases allowing flexible, part-time employment. Since 1994 public hospitals in Thailand have recruited retired physicians to work part time.³⁵ Ghana is also experimenting with such policies. Up to two-thirds of retiring doctors and nurses apply to the Ghana Health Service to be reengaged after retirement. The first contract period lasts two years, and is renewable for two more years and an additional year until the age of 65.³⁶

Countries facing human resource shortages must also actively protect the health of existing providers, particularly those with HIV/AIDS. In low-income countries disability and death typically account for less than 10 percent of attrition among health care providers. But in Southern African countries such as Malawi, where HIV/AIDS prevalence has reached 15 percent among 15–49-year-olds, death accounted for 58 percent of the attrition of Ministry of Health personnel between 1990 and 2000—with a substantial proportion due to AIDS.³⁷ Data are scarce,

but in the highest prevalence countries the annual death rate from AIDS is estimated at 4–5 percent for education workers and 2–3 percent for health workers.³⁸ Surveys of supervisors indicate that absenteeism linked to AIDS, both from sickness and attending funerals, is also a serious issue. Most employers estimate that the costs of absenteeism are even higher than the costs of training and recruitment to replace staff lost to AIDS.³⁹

The key operational implication is that human resource management and planning—even in relatively low-prevalence settings—must address the impacts of HIV/AIDS. The disease tends to exacerbate weaknesses in human resource management and planning, and few countries have implemented systems that respond effectively to the additional strains that the epidemic places on the supply of services. Fewer than 5 of 30 ministries of education in Sub-Saharan Africa have built HIV/AIDS indicators into their management information systems or included projections of the disease's impact in their models of future human resource needs. Many countries also lack workplace policies that ensure access to prevention, antiretroviral therapy, and other support and treatment, mitigate the impacts on infected staff, and provide clear backup arrangements for staff absences. Most crucial is to protect health workers from job-related exposure to infection through appropriate training, enforceable safety policies, and adequate supplies and protective gear—and to give these workers first call on antiretroviral therapy.

Deploying Providers to Underserved Areas—A Separate Issue

In both the developed and developing world, even when overall numbers of education and health personnel balance needs, there can be wide variations in the quantity and quality of service delivery across regions. Almost always, these variations result from difficulties in deploying and retaining workers in rural areas. Although 66 percent of Ghana's population lives in rural areas, for example, only 15 percent of its physicians work there.⁴⁰

Several countries have analyzed the factors influencing the willingness of service providers to locate in remote areas. While salary compensation is one factor, other factors are just as important. But virtually all the relevant factors imply higher costs for governments. Non-financial concerns include the intellectual and social isolation that highly qualified staff can feel in remote rural communities, lack of amenities such as electricity and telephones, primitive accommodations, limited transportation availability and difficulties in maintaining contact with family and colleagues, an absence of professional support and development, lack of quality education options for children, and a mismatch between an individual's professional training and the skills required on the job.⁴¹

Countries that have succeeded in implementing multipronged strategies to provide rural services include Indonesia, which posted tens of thousands of primary school teachers to rural areas in the 1970s and thousands of skilled doctors to remote provincial clinics in the 1980s, and Thailand (box 3.4). Ethiopia, Guinea, Mauritania, and Niger provide allowances for teachers in deprived areas, and Niger has also introduced allowances for teachers in nomadic schools. The premium over the average salary varies, but in these cases is 15–40 percent. Experiences from these and other countries permit several cautious conclusions about the keys to success:

- Rural and other hardship allowances should be linked to the position, not the person. If a teacher leaves a rural post, he or she should not continue to receive the premium.
- Allowances should be calibrated to regional conditions, but differentials should be transparent and based on observable characteristics.
- Criteria for and levels of allowances must be reevaluated periodically. In Bolivia, failure to do this has led to a large share of rural hardship allowances going to schools in areas that have actually become urban over time.

BOX 3.4 Attracting doctors to rural areas in Thailand

Over the past 30 years Thailand has achieved universal coverage of basic health services and sustained improvement in health outcomes. At the heart of this success are three decades of policy efforts and incentives aimed at expanding health services and attracting doctors to rural areas. Thailand's experience illustrates the need for a multipronged approach and confirms evidence from other countries that financial incentives are not always the most important component of such efforts.

In the early 1970s Thailand introduced a bonding system that offers medical students heavily subsidized tuition if they promise to work in the public sector for three years upon graduation. Students who decline the program have to pay full tuition, which is quite high, and doctors who breach the contract must pay a large fine. During that period the government also began putting priority on rural health infrastructure, as part of a national rural development effort. Expansion of urban hospitals was halted, while rural hospitals and health centers grew significantly. So did the availability of paramedics, drugs, equipment, supplies, housing, and other amenities in rural areas.

A further reform aimed at strengthening rural service delivery began in 1994, when medical schools began increasing recruitment of students from rural areas. By 2001, 32 percent of medical students were from rural areas, up from 23 percent in 1994. Medical training was also changed, to increase exposure to rural practice, and rural doctors were given priority in continuing education programs. Experience in rural public service is now a prerequisite for residency training programs, and doctors with more than five years of rural experience can apply for a Thai board certificate—the equivalent of a doctorate.

Rural doctors receive hardship allowances, with the largest allowances going to the most remote districts. In addition, each year a rural hardship award is presented to the best doctor from a remote area, as is a rural doctor of the year award.

Since the early 1970s the difference in density between doctors in rural areas and Bangkok has been cut in half, from 1/20th to 1/10th—a dramatic improvement equaled by very few countries. In addition, the proportion of outpatient visits to public health facilities occurring in rural areas has increased from 54 percent to 82 percent. After their compulsory three-year contract expires, two-thirds of doctors in rural areas remain there. During the late 1990s an economic boom led many doctors to breach their public contracts (paying a large fine) to work in the private sector. But doctors with rural training were least likely to do so.

Source: Wibulpolprasert and Pengpaibon 2003.

As a general strategy, recruiting individuals from rural areas into service or training programs is a more effective way to increase retention and improve service delivery than trying to rotate individuals trained in urban areas to rural settings.⁴² Recent research in western Kenya shows interesting results in this respect. Since early 2004 a pilot program has enabled schools to hire additional teachers for grade 1, to cope with increased enrollment after Kenya's introduction of free primary education. Teachers are hired locally, at about one-fifth the cost of civil service teachers. Once a month a team of nongovernmental organization (NGO) researchers visits schools unannounced and records attendance of grade

1 teachers and pupils. In the first year of the program, in schools that received the funding, attendance averaged 90 percent for locally hired teachers and 73 percent for civil service teachers. Locally hired teachers were also more likely to be in class when the researchers arrived—71 percent compared with 46 percent for regular teachers. Finally, the program seems to have had beneficial effects on school accountability and performance: Average teacher attendance in the program schools is 78 percent, compared with 71 percent in non-program schools.⁴³

In sum, in many developing countries the magnitude of doctor, nurse, and teacher shortfalls relative to ambitious MDG targets

calls for pragmatic strategies for scaling up providers that represent a sharp change from traditional training systems. Such strategies include changes in recruitment standards to permit faster production of providers, maximum use of complementary, less skilled workers to leverage scarce skills, attention to international migration pressures, and incentives or rural recruitment strategies to ensure service delivery in rural areas. These strategies have enabled some countries to achieve impressive scale-ups of human development services. In some cases it appears that the supply of trained or trainable human resources could support even faster production or hiring. The next section examines financing issues that affect the scaling up of human development services.

Ensuring Sustained and Predictable Financing

The challenge of achieving the MDGs at minimum global cost implies four distinct lines of action, aimed at both minimizing costs and maximizing the efficiency of financing:

- Lowering the marginal costs of expanded service delivery as much as possible, especially through human resource strategies such as those discussed above, to leverage

scarce skills and expand provider cadres at sustainable unit costs.

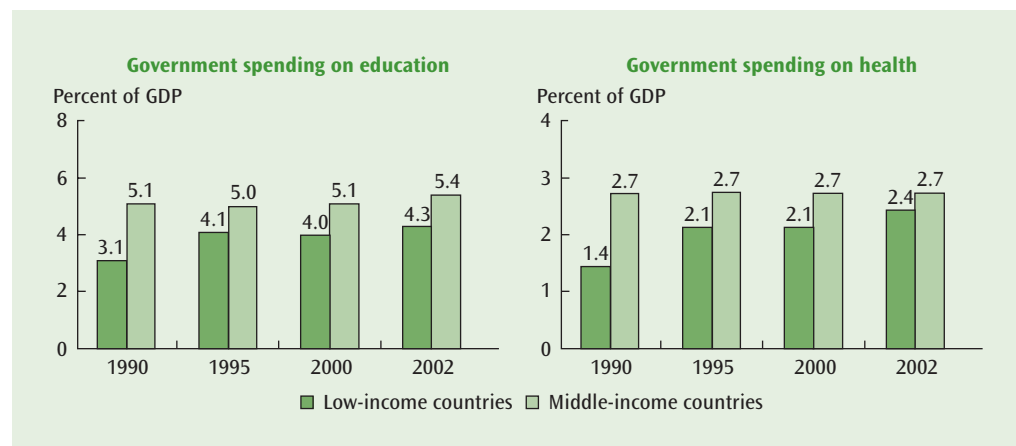
- Increasing the efficiency of service delivery, the focus of the next section.
- Increasing domestic financing for education, health, water, and sanitation in countries where fiscal allocations for these sectors are low, to minimize aid dependency.
- Mobilizing efficient donor support to fill remaining financing gaps.

Trends in Developing Countries' Spending

Between 1990 and 2002 low-income countries significantly increased their spending on education and health. In both sectors spending as a share of GDP started from a low base—3.1 percent of GDP for education and 1.4 percent for health—but it has grown by more than 40 percent in education and 70 percent in health (figure 3.12). There is little question that delivery of human development services has become a higher priority in many poor countries.

By contrast, spending shares in middle-income countries have remained relatively flat. These countries started the 1990s with much higher levels of GDP devoted to education and health than low-income countries, but the gap in health has nearly closed and in education it has narrowed considerably.

FIGURE 3.12 Low-income countries are spending more on health and education



Source: IMF data.

Note: Unweighted averages based on corresponding available data from 1990–2002.

Education and health spending also accounts for a growing share of government budgets in low-income countries. Between 1990 and 2002 education rose from an average of 12 percent to 14 percent of government spending, and health increased from 5 percent to 7 percent. The upward trend has been most pronounced in Sub-Saharan Africa, South Asia, and Europe and Central Asia, and more consistent in education than health, but overall it reflects increasing fiscal shares for the two sectors (figure 3.13). In Sub-Saharan Africa these trends show the benefits of debt relief. A recent study of African heavily indebted poor countries found that between 1998 and 2002 their spending on education and health increased by 1.9 percentage points of GDP, while debt payments as a share of GDP fell by 1.4 percentage points.⁴⁴

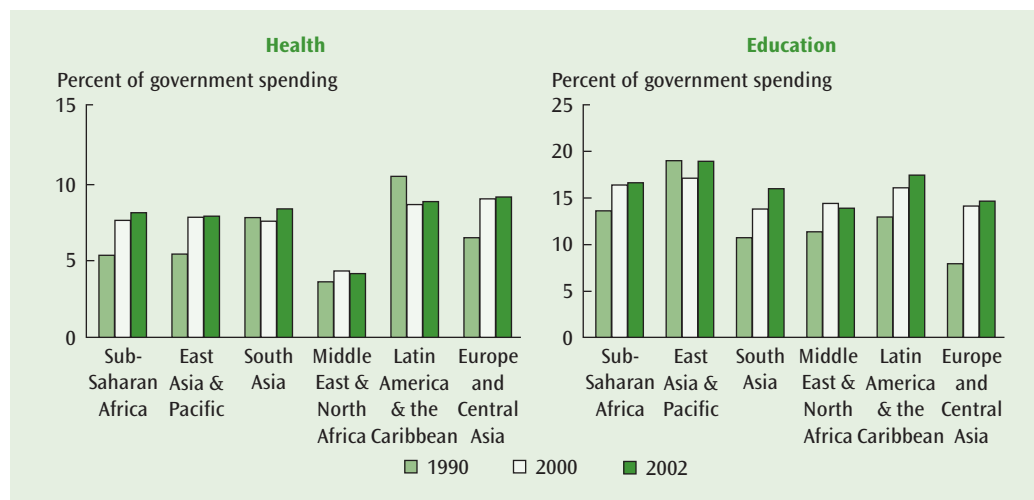
At the country level, however, there is wide variation in fiscal efforts for human development. In Sub-Saharan Africa education spending averaged about 4.9 percent of GDP in 2002—but ranged from less than 2 percent in Burkina Faso and Guinea to more than 10 percent in Botswana and Lesotho. In health the regional average was 2.7 percent of GDP, but Burundi and Madagascar spent less than

1 percent, while Eritrea, Lesotho, and São Tomé and Príncipe spent more than 5 percent. In many countries human development spending appears to be below what they could afford.

In health, though, public spending is only a small part of the story. In low-income countries as much as 70 percent of health spending is private, out-of-pocket payments to private providers. In general, as country incomes increase, both the private share of health spending and the share of private spending that is out-of-pocket—rather than for health insurance—tend to decrease. The mix of these sources has important implications for health system access, equity, and financial sustainability.

Broadly speaking, these financing trends are encouraging. Still, spending falls well short of needs. Progress on MDG outcomes needs to be accelerated for some goals in every region—and in Sub-Saharan Africa, for every goal. Even with significant increases in fiscal effort for health, in recent years slow GDP growth and rapid population increases have translated into declines in per capita public spending in several regions, most dramatically in Sub-Saharan Africa (table 3.1). If South Africa is excluded, rather than \$12 per

FIGURE 3.13 Budget shares for health and education have increased in many regions



Source: IMF data.

Note: Unweighted averages based on corresponding available data from 1990–2002.

capita in 2001, the region's public health spending drops to \$6 per capita.

Many low-income countries require substantially increased domestic financing and external aid if they are to achieve the MDGs. For middle-income countries, although not all are on track to all the goals, the case for incremental aid is less compelling—given these countries' higher fiscal capacity, closer proximity to MDG targets, and more developed health, education, and water supply and sanitation systems.

External Financing Requirements

Numerous studies have estimated the incremental costs and external financing needed to reach the MDGs. These estimates have varied widely because of the sensitivity of cost estimates to assumptions about spending efficiency, the difficulty of factoring in the impacts of synergies from progress on other MDGs, and the sensitivity of global aid requirements to assumptions about countries' own fiscal efforts in pursuit of the goals. Estimates of external financing needs are also sensitive to assumptions about the efficiency of aid in filling estimated funding gaps, an issue that has received less attention.

Table 3.2 summarizes the best available estimates of incremental spending requirements for the health and primary education MDGs. While the range is large, even the most conservative estimates of the external financing gap indicate the need to double or triple current levels of official development assistance (ODA) for health and primary education.

Investment needs in water supply and sanitation must be added to these requirements as well, because expanding these services is essential to achieving health and education goals. The overall incremental financing needs for infrastructure investments related to the MDGs (including water and sanitation) are discussed in chapter 2. It is estimated that to achieve the MDG target for water supply, annual investment must increase from \$9 billion to \$12 billion—and for sanitation, from \$4 billion to \$18 billion. Thus annual

TABLE 3.1 Public health spending per capita has fallen in some regions (current U.S. dollars, weighted by population)

Region	1997	1998	1999	2000	2001
East Asia and Pacific	15	15	16	17	19
Europe and Central Asia	100	90	77	84	89
Latin America and the Caribbean	131	132	120	125	122
Middle East and North Africa	59	61	61	66	69
South Asia	4	5	5	5	5
Sub-Saharan Africa	17	15	13	13	12
High-income countries	1,596	1,609	1,694	1,714	1,763
World	274	274	284	285	294

Source: WHO 2004.

investment in water and sanitation needs to double. Roughly one-third of this investment is needed in East Asia and the Pacific, close to one-third in South Asia, and nearly one-fifth in Sub-Saharan Africa. Even if progress in increasing private participation continues, the bulk of this financing will have to come from the public sector and ODA.

In all these sectors there is significant scope for lowering unit costs and increasing domestic financing for the MDGs in many countries. But several costing studies have examined this potential carefully and concluded that even with major increases in spending efficiency, a significant financing gap will remain.⁴⁵ The estimates of investment needs in water and sanitation presented above, for example, assume that investment and operating efficiency will be higher than in the past, due to reforms of sector management being implemented in many regions. The Bruns, Mingat, and Rakotomalala (2003) study of the costs of universal primary completion goes even further. Not only does it model improvements in unit costs and spending efficiency to best practice levels for all low-income countries, it also models

TABLE 3.2 Significant additional financing is needed to achieve the health and primary education MDGs

Countries covered	Additional financing needed annually	Additional external financing needed annually	Source of estimate
<i>Health goals</i>			
83 low-income countries	\$57 billion (2007)–\$94 billion (2015)	\$22 billion (2007)–\$31 billion (2015)	WHO 2001
135 developing countries	\$25–70 billion	Not estimated	Preker and others 2003
155 developing countries	\$30 billion (2006)–\$50 billion (2015) ^a	\$18 billion (2006)–\$33 billion (2015)	UN Millennium Project 2005 ^a
151 developing countries	\$20–25 billion	\$15–25 billion	Devarajan, Miller, and Swanson 2002
<i>Universal primary completion</i>			
79 low-income countries	\$9.7 billion	\$3.7 billion ^b	Bruns , Mingat, and Rakotomalala 2003
79 low-income countries	Not presented	\$5.7 billion	UNESCO 2002
155 developing countries	\$33–38 billion	\$5–7 billion ^c	Bruns , Mingat, and Rakotomalala 2003
151 developing countries	\$10–30 billion	Not presented	Devarajan, Miller, and Swanson 2002
155 developing countries	\$9.1 billion	Not presented	Delamonica, Mehrotra, and Vandemoortele 2001
155 developing countries	\$9 billion	Not presented	Naschold 2002
155 developing countries	\$5–6 billion	Not presented	Colclough and Lewin 1993

a. UNMP (2005a) does not provide a disaggregated estimate of global financing requirements for health. The amounts here are rough pro-rated estimates based on its five country studies, which do show the health share of MDG costs.

b. Total, not incremental, external financing requirement. Bruns , Mingat, and Rakotomalala (2003) estimate that baseline external funding for primary education to IDA-eligible countries is \$1 billion a year.

c. Total, not incremental, external financing requirement. Bruns , Mingat, and Rakotomalala (2003) do not provide a baseline estimate of external funding for primary education in middle-income countries.

increases in all countries' fiscal efforts to a best practice norm (about 20 percent of the recurrent budget and 4 percent of GDP devoted to education, with half for primary). But even under these best case assumptions, the study estimates an external financing shortfall of nearly \$4 billion a year for low-income countries to reach the 2015 goal, and a gap of \$5–7 billion a year for all developing countries.

As part of the Abuja Declaration in 2000, African governments agreed that funding for health should increase to 15 percent of their budgets, up from the current average of 8 percent. World Bank simulations for a sample of five African countries indicate that even if this spending target were achieved from 2005 on, countries would still not be able to finance the increased recurrent salary and other costs associated with scaled-up service delivery (to a target level of 2.5 providers per 1,000 population) by 2015 out of domestic resources alone. Indeed, for a few of the countries, pro-

jected external financing needs would not decline significantly until after 2020.

In sum, the incremental aid requirements estimated in even the most conservative studies are large. But for the social sectors in particular, as important as increasing the quantity of aid is the need for profound changes in its quality. The additional public spending needed to scale up human development service delivery is largely for recurrent costs, especially personnel. This spending will need to be sustained and increased over time—in many countries for a 10–20-year horizon. There is a near-complete disconnect between this core need and the nature of donor assistance to these sectors today in three major respects: aid flexibility, aid predictability, and transaction costs.

AID FLEXIBILITY

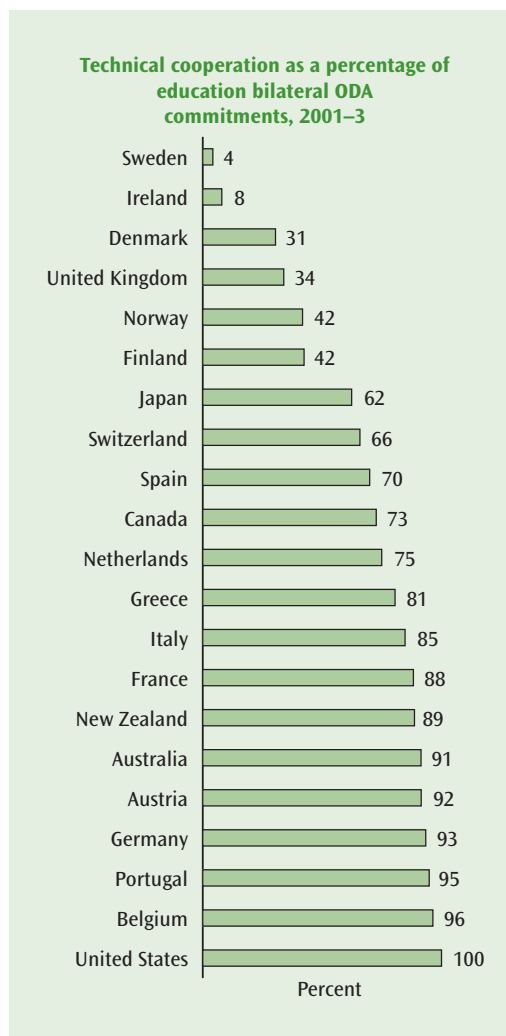
The financing gaps in health and education are for core budget expenses—largely local costs, largely recurrent, and largely for personnel.

But a high share of aid to these sectors comes pre-packaged in the form of technical assistance. About 70 percent of ODA for education is extended as technical assistance—much higher than the 30 percent share for ODA in general. From 2001–3, 10 bilateral donor countries devoted more than 80 percent of their ODA for education to technical assistance (figure 3.14).

This picture may be slightly exaggerated because some donors have difficulty isolating the nontechnical cooperation inputs of agencies that predominantly extend technical cooperation. It may also be improving somewhat, with the U.S. Millennium Challenge Account expected to start disbursing in 2005. Still, the bulk of aid for education cannot be used to pay the public sector workers that are the number one requirement for scaling up education services. No matter how important or even crucial the training, scholarships, technical advisors, and studies supported by current education aid flows may be, they do not offset the estimated financing gaps. Virtually all education MDG costing exercises have focused on the inputs that are most straightforward to cost, such as teachers, classrooms, books, student stipends, and other direct system operating costs. From the standpoint of filling those gaps and producing MDG results, the current pattern of education assistance represents a very inefficient transfer.

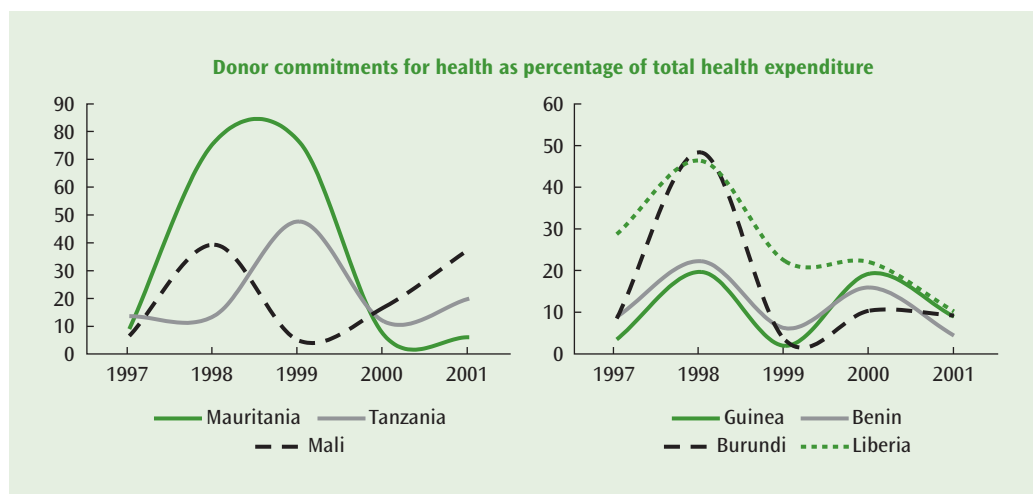
Although multilateral lenders such as the World Bank's International Development Association (IDA) report lower shares of funding for technical assistance, their funding traditionally has not been available for personnel costs either. World Bank policy has treated financing of recurrent costs as exceptional and allowed it only on a declining basis. Between fiscal 2001 and 2004 the share of Bank investment lending used to finance recurrent costs averaged just 4–6 percent. Recognizing the constraint this policy could impose on achieving the MDGs, in 2004 the Bank's Executive Directors approved a new policy on eligibility of expenditures in investment lending, including recurrent cost financing. Under the new policy, financing of recurrent costs need not be

FIGURE 3.14 Seventy percent of bilateral education aid is reported to be technical assistance



Source: Fast Track Initiative Secretariat based on OECD DAC data.

considered exceptional or occur on a declining basis. But decisions on the use of such financing must take into account its impact on the borrowing country's fiscal and debt sustainability, the country's commitment and ability to provide continued financing after Bank financing ends, and sustainability issues at the sector and project levels. The new policy is in its first year of implementation, so it is early to judge its impact. But it is expected to have a positive effect on the flexibility of IDA support for MDG-related projects.

FIGURE 3.15 Donor commitments can oscillate substantially

Source: WDI and OECD DAC donor funding database and staff estimates.

Aid is also poorly targeted to the regions and countries furthest from the MDGs. ODA for water supply and sanitation, for example, is highly concentrated, with the 10 largest recipients receiving nearly half of all such aid in 1997–2001. In 2000–1 only 12 percent of aid to the water sector went to countries where less than 60 percent of the population has access to an improved water source—which includes most low-income countries.

AID PREDICTABILITY

A second issue is the volatility of aid flows. Bilateral aid commitments—which account for 70 percent of education ODA and 50 percent of health ODA—are relatively short-term (one-to-two year) commitments, and disbursements can lag or diverge substantially from commitment amounts. Ministries of finance have raised understandable concerns about taking politically irreversible personnel actions that have long-term fiscal costs, such as hiring additional personnel or adopting wage increases to retain personnel, if it is not clear that financing will be sustained. As can be seen from the pattern of donor funding commitments for health in seven different African countries, commitments can vary tremendously from year to year (figure 3.15). While it

is true that commitments may be disbursed over several years, leading to a smoother pattern of disbursements, the volatility of commitments still impedes long-term fiscal planning.

Although low-income countries eventually need to be able to sustain their education, health, and water and sanitation systems with domestic resources—avoiding developing long-term dependency on aid—that goal can be achieved only gradually in most countries, with economic growth and deepening of fiscal capacity. In the short to medium term, countries face significant risks in expanding health or education systems in an environment where the level and continuity of donor support are largely unpredictable.

These issues are particularly acute in the lowest-income countries, which have a high degree of aid dependency and would grow even more aid-dependent in the period to 2015 under most scenarios for attaining the MDGs.⁴⁶ In health more than 30 percent of spending is already externally financed in 13 low-income African countries. In these countries (some of which appear in figure 3.15) aid volatility has pushed sector spending into inefficient stop-and-start patterns, constrained expansion, and disrupted service delivery.⁴⁷

What is needed is both provision of more stable and predictable financing by donors and efforts by the recipients to gradually build their own fiscal capacities so as to reduce dependence on aid in the long term.

TRANSACTION COSTS

A third issue is the high transaction costs that countries bear in accessing foreign aid. Even small volumes of aid for small countries flow through hundreds of parallel bilateral, multi-lateral, and global program channels, each with its own negotiation, reporting, and administrative requirements. In 2000 the typical bilateral donor provided ODA to about 115 nations. Mozambique has more than 100 development partners in its health sector alone. It is sobering to recognize that, from the standpoint of a health minister, the volatile lines in figure 3.15 showing total external financing for health are actually composites of many different financing sources and disbursement patterns, each with its own volatility and administrative requirements.

Donors often require assistance to be kept in parallel budgets outside the ministry of finance, to facilitate their accounting of the direct impact of their aid. But aid is fungible, and the cumulative demands on recipients are heavy. Low-income countries are forced to allocate limited human resources away from managing service delivery to managing donors.

There is a growing view that because aid is fungible, donors should dispense with the notion that they can identify what their money buys and focus on the entire public expenditure program and sectorwide results. In Uganda donors' willingness to increase the share of funding channeled through the government budget in the context of a sectorwide approach to water has slashed transaction costs and sped implementation of rural and town water supplies. Donor support for water going through the national budget increased from 14 percent in 2000 to 44 percent in 2002 and will reach 70 percent in 2006. In parallel, Uganda's annual investment in water points and town water supplies has reached twice that of similarly sized countries.

In education, pooled donor support for single, agreed sector investment programs has been a major thrust of the Education for All Fast Track Initiative (see the next section). This approach is increasingly being discussed in health as well. Harmonization is also being advanced more generally through the Rome, Marrakech, and recent Paris meetings and ongoing work by OECD's Development Assistance Committee to implement country partnership and harmonization agreements.

Are Global Programs Advancing the MDGs?

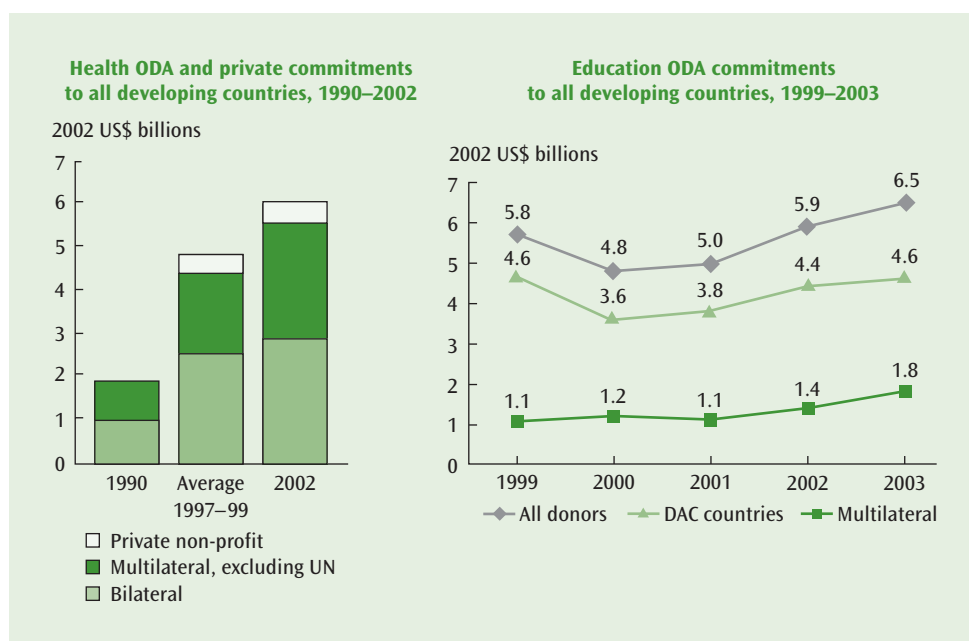
Development assistance for health has risen steadily since 1990 and significantly since the MDGs were adopted in 2000 (figure 3.16). In contrast, support for education declined between 1990 and 2000, but increased by 35 percent in real terms between 2000 and 2003.

HEALTH

In health much of the post-2000 increase in ODA and private philanthropic funding (notably the Gates Foundation) can be credited to new global programs aimed at mobilizing global awareness and funding to eradicate major diseases. Major global programs in health include the Global Fund to Fight AIDS, Tuberculosis, and Malaria (GFATM), the Global Alliance for Vaccination and Immunization (GAVI), the World Bank's Multi-country AIDS Program (MAP), the U.S. President's Emergency Plan for AIDS Relief (PEPFAR), and some 70 other global health initiatives. The impact on HIV/AIDS funding has been particularly large: By 2003, almost 80 percent of public spending on HIV/AIDS in low-income countries was financed by external grants.⁴⁸

These new global initiatives have transformed the landscape in the health sector. In just three to five years the programs have had three major achievements:

- *Raising global awareness of key diseases.* The global health initiatives have been very effective in drawing donors' attention to

FIGURE 3.16 Total ODA for health and education is increasing

communicable diseases such as malaria, tuberculosis, and HIV/AIDS that are major killers in the developing world, as well as to less-known tropical diseases that disproportionately affect low-income countries—such as riverblindness, Chagas disease, and dengue fever. This advocacy has had a major impact on funding for malaria, tuberculosis, and HIV/AIDS, all of which are key for MDG progress. Some of the resulting partnerships, notably for river blindness, have also been catalysts for the cross-border collaboration needed to produce results. The global programs have played an equally important role at the country level, in encouraging developing country governments to revitalize programs for these sometimes neglected diseases. Finally, they have helped improve the delivery of interventions, often by contributing drugs.

- *Stimulating new drug and vaccine research.* The global health initiatives have used innovative approaches and market power to stimulate research on the drugs and vaccines needed by developing countries; they

have also stimulated production and helped lower prices. In noncompetitive markets, such as those for vaccines against childhood illnesses, guarantees of future purchases and sharing of risks with producers have been used by the Global Alliance for Vaccines and Immunization (GAVI), for example. In competitive markets, programs such as the Tuberculosis Global Drug Facility have been effective in expanding access to high-quality drugs at reduced prices through pooled financing and commodity purchases. The Malaria Medicines Supply Service is proposing to use globally pooled procurement to increase purchaser leverage and reduce prices, while at the same time creating demand for artemisinin combination treatment (ACT) and expanding markets.

- *Making aid for health pro-poor.* The resources of global health initiatives are more focused on low-income countries than are donor commitments overall, and a high proportion of their resources are dedicated to communicable diseases, which disproportionately affect the poorest people in

low-income countries. Support from the initiatives is directly pro-poor, and they have been very effective at leveraging additional funds from foundations. Finally, they promote cost-effective interventions.

Against these achievements, however, there is a growing realization that the “verticalization” of health sector support through diverse, specialized global initiatives is having adverse effects. All the new global programs have put substantial effort into establishing lean and technically proficient administrations, careful accounting of funding and results, and innovative approaches to program delivery—including, for example, channeling funds directly to NGO providers. But their cumulative impact is to undermine the capacity of ministries of health for coherent planning, financing, personnel deployment, and administration.

A recent study of 14 low-income countries found that the multiplicity of global programs, on top of existing multilateral and bilateral channels, is exacerbating transaction costs and distorting sector priorities.⁴⁹ There have been numerous instances of different teams of technical experts with identical terms of reference visiting a single country, and different donors promoting conflicting approaches and priorities. Citing recent proposals in Guyana and Tanzania for HIV/AIDS treatment programs that equal half of existing health budgets, the report argues that such programs—driven by global financing availability rather than national poverty reduction strategy priorities—may draw disproportionately on health sector staffing and other resources.⁵⁰ Of equal concern are reports of agency turf fights and other coordination difficulties at the country level. An IMF mission recently concluded that bureaucracy and infighting linked to different specialized programs were the main reason one African country was unable to disburse more than 20 percent of available aid for health in 2004 (box 3.5).⁵¹

If ODA for health in support of the MDGs is to produce the desired results, a new framework is needed. Given the predominantly

recurrent and local nature of financing needs, there is a strong case for providing the bulk of funding as general or sectoral budget support. Equally important is that all donor support be organized around a country-led health strategy that encompasses HIV/AIDS, malaria, and all other disease priorities in a balanced and coherent way. The sector strategy should be fully aligned with the country's poverty reduction strategy and consistent with its medium-term expenditure framework. No donor assistance should be “off plan” or off budget, and the first priority for donors should be to fill financing gaps in implementing the poverty reduction strategy.

But for donors to accept flexible transfer of their funding through national budgets, there must be a *quid pro quo*: Country public expenditure management and sector monitoring must meet performance standards that assure citizens of donor countries their money is resulting in efficient service delivery—and that those services, over time, are producing MDG results.

EDUCATION

Such a “compact” between countries and donors figures prominently in the Education for All Fast Track Initiative (FTI). Consistent with the Monterrey consensus, the initiative aims to ensure developing countries committed to universalizing primary completion the technical and financial support they need, in exchange for increased accountability for results. In contrast to health, there is a single global partnership to support MDG progress in education, which all education donors have formally agreed to. Also in contrast to the global health programs, the core objectives of the FTI are to support countries’ development of a coherent education strategy and promote coordinated—and more efficient—donor support. To make technical assistance more efficient, donors have agreed to a pooled Education Program Development Fund at the global level to help countries develop credible education strategies and costed programs—and reduce the welter of uncoordinated, overlapping studies and capacity building initiatives. At the country level, all

BOX 3.5 IMF programs and MDG progress

The International Monetary Fund (IMF) has a clearly stated policy of ensuring appropriate flexibility in fiscal targets, including by seeking and accommodating higher aid flows in countries supported by its Poverty Reduction and Growth Facility (PRGF). How is this policy being implemented? What impact is it having on government spending and MDG progress in low-income countries? Why do critics continue to assert that IMF programs constrain countries' ability to scale up health and education service delivery? Consider the facts in three African countries.

Zambia. Some 16 percent of Zambia's adult population is HIV positive, and the government has set a target of reaching 100,000 Zambians with antiretroviral treatment by the end of 2005. In its fight against HIV/AIDS, Zambia is receiving support from the World Bank's Multi-country AIDS Program (MAP), the Global Fund to Fight AIDS, Tuberculosis, and Malaria, and the U.S. President's Emergency Plan for AIDS Relief (PEPFAR). Resources from the MAP and Global Fund are mainly channeled through the National AIDS Council, while the PEPFAR operates largely outside the government budget. Efforts are now under way to compile a comprehensive database that tracks these inflows to improve coordination.

Funding to combat HIV/AIDS is rising sharply, and there now appears to be a problem of absorptive capacity. This is not a result of any direct or indirect limit on spending or hiring under the IMF-supported program. No limit has been placed on external funding of HIV/AIDS programs or hiring of health workers in the program. The budget for 2005 makes special efforts to ensure the employment and retention of available health workers. However, external sources of funding to HIV/AIDS typically do not cover personnel.

Uganda. Uganda has achieved considerable success in reducing HIV prevalence rates through aggressive public sector efforts at prevention and, now, treatment. Between 1998 and 2005 the health budget increased from 1.8 to 2.6 percent of GDP. Additional annual health resources of up to 2.0 percent of GDP are available from the Global Fund and PEPFAR. Nearly 40,000 Ugandans are currently on antiretroviral therapy. The authorities hope that by the end of 2005, 60,000 people will benefit from this therapy (out of 120,000 who need it).

The IMF's PRGF arrangement with Uganda includes a "ring fence" to protect health care and other poverty-related spending from within-year budget cuts, and promotes a progressive shift in resources to social programs—for example, by seeking to limit growth of nonpriority spending such as on public administration. But adequate budget resources are not the only issue. Improvements are needed in the management of Global Fund and other health resources to accelerate the use of approved funding (currently less than 20 percent of funding has been used). Capacity also needs to be enhanced in the health sector, notably through training additional nurses and doctors.

Kenya. Kenya's HIV infection rate is estimated at 14 percent of the adult population. The fiscal framework underpinning the PRGF-supported program reflects Kenya's poverty reduction strategy priorities, including the fight against HIV/AIDS—including actions to increase the number of AIDS patients on antiretroviral therapy.

The Global Fund, MAP, and PEPFAR are expected to disburse \$32 million a year over 2005–6 to support the government's AIDS program—about 0.2 percent of GDP. The government estimates that AIDS treatment targets will require hiring 4,000 more nurses in addition to the estimated 2,000 additional nurses needed for the overall health system. The Global Fund has agreed to provide financing for 725 nurses on two-year contracts, under prevailing pay scales. While the current IMF program places limits on the size of the core civil service establishment, teaching, health, and security services are excluded. It has been agreed that these services may hire additional personnel to fill the 3,000 positions lost by the core civil service through natural attrition.

Source: IMF Africa Region staff.

education donors participate in ministry of education-led coordination groups, with a rotating donor “lead” agency. While such groups had arisen in some countries previously, they were not a systematic practice.

Country-level donor groups have three key responsibilities: review and collectively endorse the sector plan, align their financing with the country’s priorities, and monitor progress in improving education spending efficiency, through a set of agreed performance indicators. Indicators include key outcomes, such as the primary completion rate and the gender ratio in education, and key intermediate indicators, such as the repetition rate, the pupil-teacher ratio, the share of education in public spending, and the share of education spending on books, materials, and other crucial quality-enhancing inputs.

Making each dollar of education spending go further is a joint priority under the initiative’s “compact.” Donors have also agreed that their progress in increasing aid efficiency should be monitored annually and reported transparently. At the March 2005 High Level Forum on Harmonization and Alignment in Paris, donors committed to a specific set of harmonization indicators (see chapter 5). Progress on these indicators will be monitored by the OECD’s Development Assistance Committee (DAC). The FTI, which involves both country-level coordination groups and regular global meetings to monitor progress, offers a ready-made channel for disseminating the indicators and working with education donors on these agreed areas of harmonization and alignment. The initiative’s secretariat, for example, is helping to turn principles into good practice by developing sample memorandums of understanding and common guidelines for assessing the quality of education sector plans.

The FTI was launched in June 2002. What has it accomplished? There is general consensus on two conclusions:

- The initiative is having a positive impact on donor coordination at both the country and global levels. Honduras’s minister of education called this the initiative’s greatest bene-

fit, and countries such as Nicaragua, Vietnam, and Yemen have credited the initiative with bringing the donor communities in their countries together—and creating discipline around a country-led, coherent process of education planning and priority setting linked to their poverty reduction strategies. At the global level the FTI has promoted ongoing dialogue and information sharing among donors, through semi-annual meetings and working groups focused on priority issues such as tracking of aid flows and harmonization.

- A continuing challenge for the initiative is countering skepticism about its ability to mobilize substantially increased funding for the education MDG. Although a first set of endorsed countries has received significant additional support, the number of countries is small and the commitments are fairly short term. Moreover, many more countries are poised to enter the initiative. As part of the global stocktaking of MDG progress in 2005, donors need to develop options for a more stable funding framework for the FTI.

In contrast to the global programs in health, the FTI started with little upfront funding. Instead, donors pledged to commit additional resources to specific countries once their sector plans had been endorsed and financing needs established. The rationale was that channeling incremental funding through existing bilateral and multilateral mechanisms would speed disbursements and avoid the increased bureaucracy and transaction costs of setting up new global funds. With initial support from the Netherlands (subsequently joined by Belgium, Italy, Norway, and the United Kingdom), however, a \$235 million trust fund was established in 2003, called the Catalytic Fund. Given its size, the fund was not designed to be the primary financing channel for primary education support. Rather, it provides transitional (two- to three-year) financing to endorsed countries with only a small number of active donors (“donor orphans”) until larger and more sustained

volumes of aid can be attracted from new bilateral or multilateral channels.

While this approach has kept administrative and transactions costs lower than in the health sector, it is difficult to argue that it has worked well from the perspective of mobilizing the incremental aid volumes needed to achieve the education MDG. The financing gaps for the first seven countries endorsed by the initiative have been closed, but it took almost two years to do so, and transitional support from the Catalytic Fund has played a large role. The additional commitments for these seven countries represent a 30–40 percent increase in their ODA for primary education, but the new commitments extend only to the end of 2006. The gap-filling has not been timely, and the assurance of sustained and predictable financing is largely absent.

Another five countries, endorsed in 2002–3, still have financing gaps totaling \$260 million (over three years). And in 2005 as many as 25 additional countries could meet the FTI endorsement requirements (having a poverty reduction strategy and an agreed education plan), raising global financing needs for the program to an estimated \$1.7 billion in 2005 and more than \$3 billion a year from 2006.⁵² From a developing country standpoint, however, there has been no credible indication from the initiative's donors that these amounts are being programmed.

The FTI's country-driven model, its alignment with Poverty Reduction Strategy and Medium Term Expenditure Framework planning and budgeting, its focus on monitoring results and spending efficiency, and its active promotion of donor harmonization are all important achievements. Its donors now need to develop a fundraising model that ensures a substantially increased volume of sustained, predictable funding for countries with credible education plans and good implementation performance.

Making the Money Work

Achieving the MDGs will depend above all on developing countries' ability to achieve stronger

public sector performance in delivering services. The challenge is essentially political. The evidence that aid works best where policies and governance are good is influencing aid flows, and this trend will intensify. While some donors suggest that a viable strategy in weak states is to bypass the public sector altogether, no OECD country has ever achieved universal health or basic education coverage with mainly private systems—in fact, most are heavily public. Both for-profit and nonprofit private actors will likely play more important roles in the development of these sectors in low-income countries, especially low-income countries under stress (box 3.6), and especially in water and sanitation. But even where services are privately provided, effective state capacity is required to perform the core functions of mobilizing revenues, planning, costing and prioritizing sector investments, setting standards and policies, contracting with providers, and monitoring outcomes.

The World Bank's *World Development Report 2004* documents the many ways in which the public sector in developing countries fails in service delivery, particularly for poor people. Even where spending on education and health absorbs a high share of GDP, key outcomes can be weak (figure 3.17). Studies consistently confirm the weak relationship between social spending and outcomes—especially in health—and the two main causes. First, spending may not be allocated to the types of services that most directly affect outcomes. Health spending on hospitals, for example, does not have as much impact on child mortality rates and malaria incidence as does spending focused on immunization programs and malaria control.

The second issue is that even where resources are allocated to the basic education and primary health care services most closely linked to MDG outcomes, the chain of people and transactions through which resources flow down to frontline providers is long, geographically dispersed, dependent on the discretionary behavior of many individuals, and open to leakage at many points. The core services that frontline teachers and doctors provide are complex and individualized, making them difficult

BOX 3.6 Scaling up service delivery in low-income countries under stress (LICUS)

Low-income countries under stress are defined by their weak policies and institutions. Many have recently emerged from or been affected by conflict. Achieving effective service delivery in these circumstances is a challenge. Nevertheless, successful approaches are emerging, including some that feature the use of local institutions or that work with nonstate actors in ways designed for eventual transfer to state delivery.

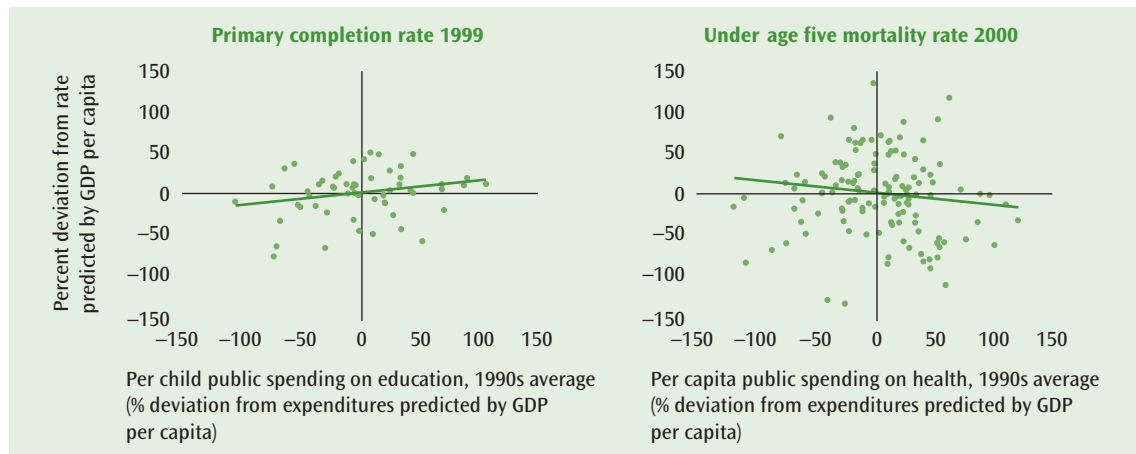
In countries where national institutions are weak, it may seem counterintuitive to look to the subnational levels of government to provide services. But in a number of low-income countries under stress, it is at the local level that formal and informal institutions often demonstrate the most capacity to manage and allocate resources. Community-driven development and social fund approaches have been widely used and proven well suited to these country contexts.

The Northern Uganda Social Fund, for instance, supports construction and rehabilitation of social and economic infrastructure that is identified, managed, and implemented by local communities in conflict-affected areas. In Afghanistan community forums helped ensure vital services and income generation opportunities in local areas during a period of state collapse. Supported by small grants to cover initial costs, the forums relied mostly on community mobilization and cost recovery to organize and finance services. They gradually developed relationships with local governments and donors to become key development actors at the local level. Their highly flexible approach allowed them to respond to community initiatives and local conditions, and later to become the basis for a social fund after the fall of the Taliban. Until recently their model of representative governance was unique in Afghanistan and contributed to the local reduction of ethnic tensions at a time when ethnicity became heavily politicized and a driver of conflict. The project laid the basis for the new National Solidarity Program, which operates at scale and has been instrumental in bringing both participatory processes and a positive state presence to many remote areas.

Particularly in postconflict countries, experience shows that it is important to give early attention to building the capacity of government actors to take responsibility for service delivery, as well as to restoring basic services quickly. In Timor-Leste health indicators improved significantly in the four years following the country's crisis, through a strategy that balanced these two goals. The program worked simultaneously on short-term needs such as reconstruction of health facilities, through government contracts with nongovernmental organizations (NGOs), and medium- to long-term goals such as developing a national health policy, pharmaceutical logistics systems, human resources for health, and gradual handover of NGO contracts to government.

Source: World Bank LICUS unit.

FIGURE 3.17 Higher spending on education and health does not always mean better outcomes



Source: World Development Report 2004.

Note: Regression line shown: Coefficient = .157, T-statistic = 1.70.

Note: Regression line shown: Coefficient = -.148, T-statistic = 1.45.

to monitor and manage. Difficult working conditions, uncompetitive salaries, and higher status relative to illiterate and unempowered families can undercut providers' accountability to clients and foster absenteeism and low quality. Inefficiency in the use of available resources, arising from all these sources, can be large.

The case for additional aid, especially in the form of flexible budget support, will depend on countries' ability to show that funds are well managed and producing MDG results. And as the *World Development Report 2004* emphasizes, reforms to improve service delivery must address not only its proximate causes—no drugs in clinics, teacher absenteeism, no water connections in poor urban areas—but also the underlying power and accountability relationships linking citizens, politicians, and service providers that are the cause of persistent inequity and inefficiency in the use of public resources. Progress in many settings will require actions on all three dimensions of the “accountability triangle” linking citizens, politicians, and service providers. It will require broad reforms to improve governance and increase the responsiveness of elected officials to citizens, strategic actions to improve the management of resources and performance along the service delivery chain, and strengthening of “client power,” or citizens' ability to demand better basic services directly from frontline providers.

Improving Governance

The broad structures at the foundation of good government—the rule of law, control of corruption, sound economic management, representative governance, and independent media—are crucial for macroeconomic growth and foreign direct investment. They also have direct repercussions on the equity and efficiency of public services.

Jump-starting progress toward the MDGs can require decisive actions to prioritize universal coverage of basic services over the interests of politically influential stakeholders. It has involved such politically difficult actions as

shifting to contract teachers to make the costs of expanding schooling more sustainable, at the price of opposition from teacher unions; eliminating fees for basic health services for the poor while retaining them for upper-income groups; shifting to low-cost construction of schools and clinics by communities rather than more expensive national or international contractors; and resisting pressures from teachers and parents for smaller classes until universal coverage is achieved.

All these actions to lower the unit costs of basic services or recover costs from those who can afford them promote faster achievement of universal coverage. Countries that have made the fastest MDG progress have given priority to coverage for all, adopted cheaper but “good enough” service delivery models initially, and focused on improving quality over time. These political choices are unlikely in contexts where the voices of the groups that would benefit from universal access are weak and the influence of institutional stakeholders, such as medical or teacher unions, is strong. A recent study of Georgia concluded that slow progress on the health MDGs and underfunding of MDG-related health services were much more a “failure of citizens to exercise their voice power and the ability of politicians to remain largely unresponsive to the poorly expressed demands than of resource limitations per se.”⁵³

But progress is being made. In most developing regions, two decades ago democracy was the exception; now it is the rule. Political representation, transparency, corruption, and the quality of public administration are being openly evaluated with a number of international indexes, and most are steadily improving. Since 1999 the average ratings for Sub-Saharan African countries on the World Bank's policy and institutional assessment index (CPIA) have been stable or increasing in all five areas (quality of budgetary and financial management, efficiency of revenue mobilization, quality of public administration, property rights, rule-based governance). The New Partnership for Africa's Development (NEPAD) has developed a peer review

mechanism that uses transparent national assessments by teams from neighboring countries to highlight governance weaknesses in African countries and encourage improvements (see chapter 2 for more on NEPAD and the African Peer Review Mechanism).

One of the most critical areas for progress is public expenditure management. Achieving the health and education MDGs will require greatly increased volumes of flexible aid channeled through national budgets. But in many of the low-income countries in greatest need of external recurrent cost support, budget systems are too weak to give donors confidence that resources can be tracked and well used. Systems for budget formulation, execution, and reporting must be able to meet threshold standards of integrity and efficiency.

Under the Heavily Indebted Poor Countries initiative the IMF and World Bank have worked with countries on benchmarks for measuring capacity to manage priority public spending. Although a first assessment of 24 countries in 2002 found no country with a fully adequate system and most in need of substantial upgrading, many countries showed progress when they were reassessed in 2004 (see chapter 2 for more details). Mali and Tanzania advanced to the category of “little upgrading needed,” and Ghana and Senegal showed substantial progress. For the group as a whole the average number of benchmarks met increased from 6.0 to 6.5 out of a possible 15. Much more is needed, obviously, but trends are in the right direction. But countries’ performance against these indicators can be expected to play a major role in their access to expanded aid in the form of budget support.

Managing the Service Delivery Chain

Broad improvements in political responsiveness to citizens and in public expenditure management should increase the resources available for MDG-related services. But it is the service delivery chain—institutional performance and policies in the education, health, water, and sanitation sectors—that transforms

financing into coverage and coverage into outcomes. Substantial country evidence shows that both links can be problematic. But country experience also points to four important strategies for strengthening provider accountability and system efficiency.

MEASURE RESULTS, PERFORMANCE, AND IMPACT

Fundamental for progress is measurement of performance and results. At present, countries are far from real-time tracking of MDG progress for virtually all the goals and indicators. To focus health and education systems on key results, countries need better and more timely administrative data. Capacity building in this area should be a priority, but it must be carried out in new ways that avoid the wastefulness of incompatible management information systems financed by different donors and technical assistance that fails to build true local capacity. Countries also need household surveys at regular intervals—such surveys are essential for tracking MDG outcomes by income quintile, gender, ethnicity, or region.

The World Bank and the United Nations Educational, Scientific, and Cultural Organization’s Institute of Statistics should put coordinated emphasis on building countries’ capacity for consistent annual reporting of primary school completion and build up the Primary Completion Database they have jointly launched. The targets for the second MDG, on primary school completion, should also be expanded to include some measurement of student learning. Universal primary completion is a meaningful goal only if it signals that children have learned, and in an economically integrated world this threshold level of skills and knowledge should be a globally relevant one. Donors should support work by a consortium of international testing agencies on a culturally neutral global “core curriculum” that can be embedded in the various regional learning assessments in use today. Countries not participating in regional assessments should be encouraged to do so. And strengthening national assessment systems should be a

priority area of support. Equally important is making results known to parents and communities. Albania, Romania, and Turkey, among other countries, have recently made important strides in broad public diffusion of student learning results.

Most MDG outcomes improve relatively slowly, so intermediate indicators of progress are also important—above all, measures of system efficiency. The FTI “indicative framework” for monitoring education sector performance is transparent and permits direct comparisons of countries’ progress; a similar framework is being developed by a donor consortium in health (Health Metrics Network). These new approaches will work to the advantage of countries committed to better performance.

Finally, rigorous evaluation of the impact of development programs builds the knowledge base for better policies. Considerable resources are devoted to evaluation studies today, but the failure to establish clear baseline data or appropriate controls often compromises the quality and policy value of the results. Several recent examples, including the Progres/Oportunidades conditional cash transfer program in Mexico and school health interventions in Kenya, attest to the role that well-designed evaluations can play in persuading policymakers to expand or sustain programs, even across changes of government.

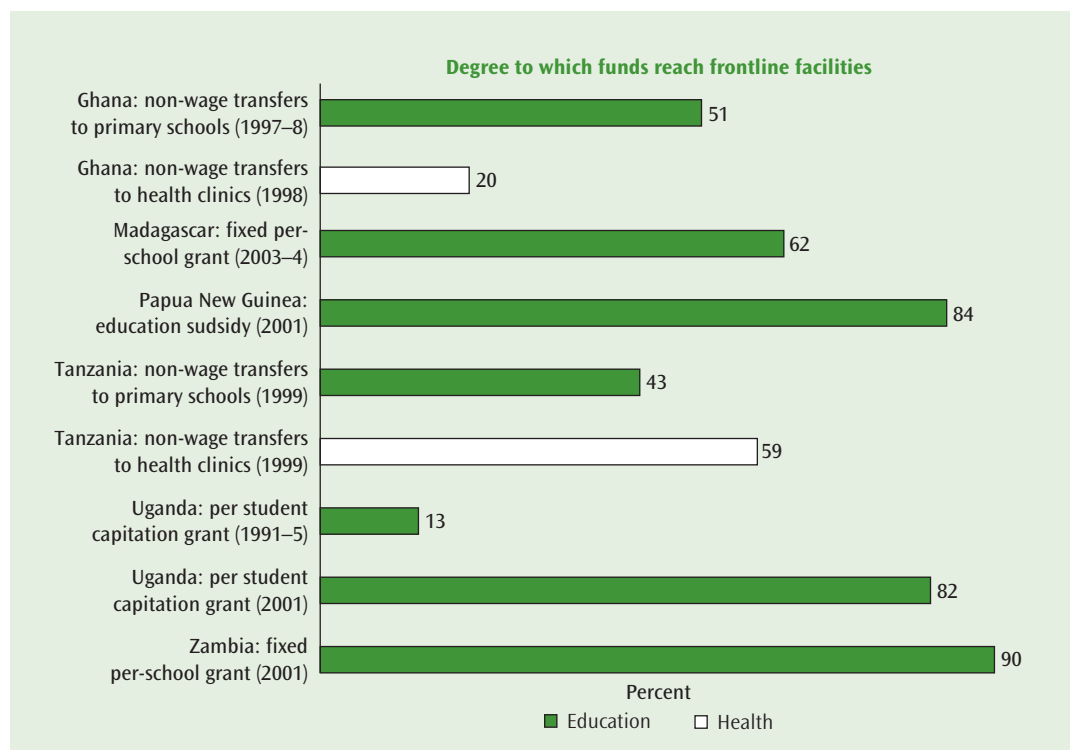
One of the most crucial questions for policymakers is how a program or policy’s design will play out in different country circumstances. This kind of knowledge, which can be derived only from comparable evaluations across countries, is a global public good—and the costs of generating it need to be broadly shared by the international development community. The World Bank is especially well-positioned to identify programs with similar objectives and design features being implemented in different parts of the world, and to support systematic and rigorous evaluations of their impact. Through the Bankwide Development Impact Evaluation (DIME) initiative and efforts by the Bank’s Human Development Network to organize

impact evaluations of key types of education, health, youth employment, and early child development programs, there has been a sharp increase in attention to this area over the past year. It should be strengthened further, with expanded support from donors to build capacity in low-income countries for data collection and analysis and to broadly diffuse evaluation results. Developing country policymakers and their donor partners should also provide a “demand side” stimulus to impact evaluation, by systematically asking for the evidence base when considering new programs or policy proposals.

USE TRANSPARENT ALLOCATION RULES AND THE POWER OF INFORMATION

A core issue in education and health service delivery is getting funds to the frontlines, where services are delivered. Setting simple, clear norms for the allocation of funding has been a boon to more efficient and equitable service provision in both developed and developing countries. In education, “funding follows the student” reforms have had dramatic effects in countries ranging from Brazil to Australia. In Brazil a 1997 reform that set a minimum floor on education spending in all regions sharply increased resources for the poorest (Northeast) region, and nationally caused primary enrollments of children from the lowest income quintile to rise from 55 percent to 85 percent—in the space of six years.

Norms for the allocation of personnel or other inputs (such as medicines or books) can also be established and clearly communicated to each facility. In addition, fees for health services and drugs should be posted transparently, to ensure that patients are charged fairly and collected funds are not diverted. In Georgia prominent posting of the fee schedule in the children’s hospital in Tbilisi has curbed excessive payments and significantly increased hospital revenues.⁵⁴ In water and sanitation, Burundi and other countries have significantly increased investment efficiency by setting clear guidelines, disbursement procedures, and performance indicators for civil

FIGURE 3.18 Leakage of funds can be high but is not inevitable

Source: Kushnaroova 2005.

works contractors, with oversight provided by nonprofit contract management agencies. As a result water and sanitation project execution has improved dramatically in Burundi, with invoice payment time averaging 5 days—compared with 90 days elsewhere in the central government.

The positive impact of clear funding rules on leakage is shown by public expenditure tracking studies, which document enormous variations in the degree to which funds intended for frontline facilities actually reach them (figure 3.18). Leakage estimates are not comparable across countries and sometimes simply reflect a failure to record transfers properly, not a failure of resources to arrive. But the studies show that even in the same country, results can vary substantially under programs with different designs. Leakage is not an inevitable feature of low-income settings.

Clear allocation rules have the greatest impact if they are widely known. Uganda raised the share of per student capitation grants that made it to schools from 13 percent in 1991–5 to 82 percent in 2001 by publishing monthly data on the transfers in newspapers, broadcasting it on the radio, and having primary schools post notices of their entitlements and the amounts actually received. For the first time, parents had the information they needed to understand and monitor the grant program.

Subsequent research in Uganda has documented that throughput to the school level is most efficient in areas where newspaper penetration is highest—pointing to the power of information.⁵⁵ And a new study shows that, controlling for other factors, schools with higher transfers show more improvement in student learning.⁵⁶ Uganda's story points to three key messages for MDG progress:

- Clear, equitable norms for managing key inputs—be it personnel allocations or funding for books or drugs—are important.
- Broad use of the media and transparent reporting at the facility level can unleash “client power” and pressures for improvement.
- It is important to go the extra step to analyze not just progress in reducing leakage, but also its impact on outcomes, such as student learning or community health indicators.

Few countries have done all these things, but the growing number of countries using Public Expenditure Tracking Surveys (PETS) and Service Delivery Surveys to measure frontline funding and service quality is encouraging.

FOCUS ON PROVIDER QUALITY, DEPLOYMENT, AND INCENTIVES

Skilled providers are the most expensive element of health and education systems; recruiting, deploying, equipping, and supervising them carefully are key to maximizing the productivity of spending. Yet very few countries recruit teachers on the basis of tests measuring their subject mastery and what they can do in the classroom. Far more common are the practices of Colombia, where teachers and headmasters are routinely hired based on party affiliation regardless of their experience, training, or knowledge,⁵⁷ or Cameroon, where headmaster posts are sold.⁵⁸

Deployment is also poorly managed in many settings. In Ethiopia each health worker in the Afar region handles 1,200 outpatient visits a year, in Addis Ababa 680, and in Gambella just 82.⁵⁹ The implication? If health care workers were posted more efficiently across the system, achieving Afar’s degree of productivity everywhere, the Ethiopian health care system could dramatically increase service delivery with the current number of workers.

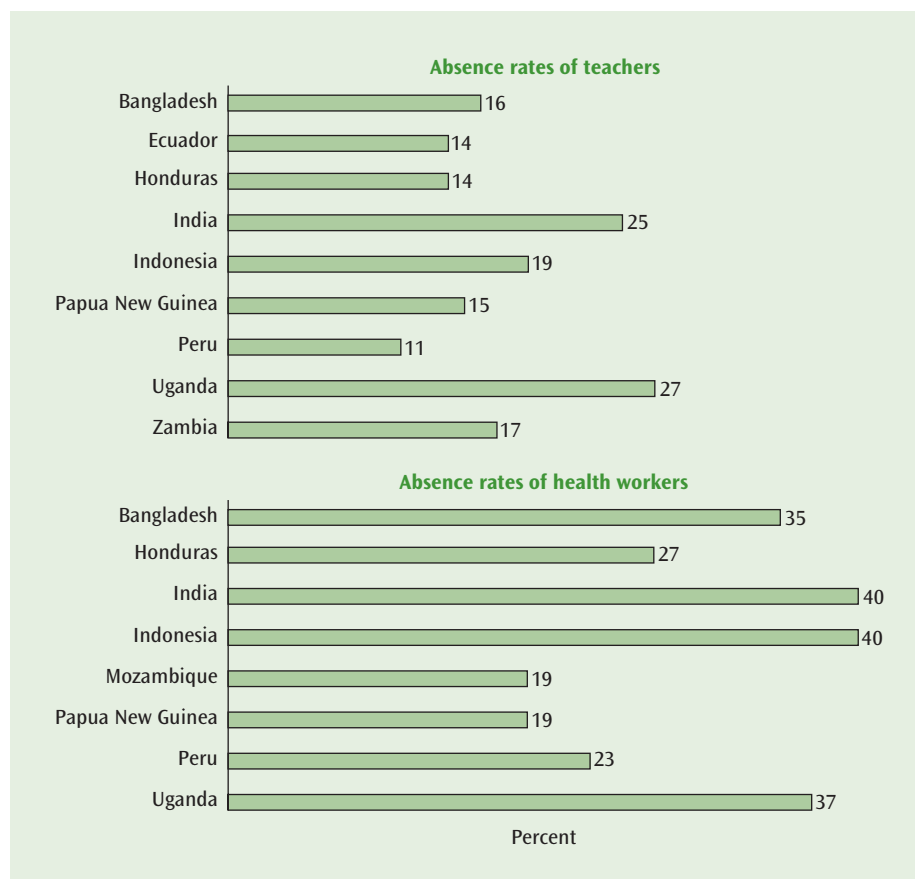
Similarly, studies in Sub-Saharan Africa find some countries doing a far better job of allocating teachers equitably across schools. Whereas in Benin 39 percent of teacher postings deviate from the official norm of 40 stu-

dents per teacher, in São Tomé and Príncipe only 3 percent do. Deviations from official norms almost always reflect an oversupply of teachers in more appealing urban areas and low service provision in rural zones.⁶⁰ Countries seeking better MDG outcomes can start by examining factors like these.

Even when providers are deployed relatively efficiently, poor incentives, weak management, widespread illness, and other factors can cause high rates of provider absence. Surveys of service delivery that make unannounced visits to a sample of facilities show consistently high absence rates among teachers and health workers (figure 3.19). The problem is especially acute among doctors, who have a ready private market for their services. In Bangladesh absentee rates for physicians average 74 percent at small rural posts.⁶¹ Provider absence seriously disrupts service delivery and undermines MDG outcomes. In Nigeria a 2003 project to track effective hours of instruction found that almost half the annual school hours in Kano, Nasarawa, and Lagos were lost because of teacher and pupil absences.⁶²

Studies that have examined this issue in detail have found that it is not simply a question of salary incentives. In Bangladesh the highest-paid teachers were most likely to be absent.⁶³ And in India, as well as Bangladesh, a large share of teacher absences were excused absences for training and other administrative processes. Many providers posted to remote rural areas, for example, must travel long distances to pick up their pay—and must do so on business days. Countries concerned about MDG outcomes need to address these managerial issues.

Average salaries for skilled providers may need adjustment in many contexts, to counter providers’ incentives to migrate internationally in health or to extract informal payments. But there is abundant evidence that effective incentives are not just a question of average salaries, or even salary dispersion, although—if tied to performance evaluation systems perceived as fair—this can help. Nonsalary inducements (such as housing, research and training oppor-

FIGURE 3.19 Absence rates can be very high, especially in health

Source: Kushnarova 2005.

Note: Based on studies/surveys conducted between 2000 and 2004.

tunities, and public recognition) are important, as are accountability pressures through, for example, effective supervision. In Karnataka, India, the Learning Guaranty Program is an innovative attempt to strengthen incentives for public education providers to focus on outcomes that really matter—how well they serve all children in the community, and how much children learn (box 3.7).

MAKE GOOD USE OF THE PRIVATE SECTOR

Comparisons of service delivery norms and outputs in public and private facilities often reveal large differences in efficiency. Although the Christian Health Association of Ghana employs only 17 percent of health sector

staff, it handles 41 percent of hospital patient visits (outpatient and inpatient) and 27 percent of health clinic visits.⁶⁴ Evaluations of Jesuit-run Fe y Alegria schools in nine Latin American countries have found that the schools systematically outperform public schools, with lower repetition and dropout rates and higher graduation rates—despite the fact that resources per student are the same or lower in Fe y Alegria schools and the schools cater to disadvantaged students.⁶⁵

The higher efficiency of private providers can have major benefits for poor people's access to services and for MDG progress. In Barranquilla, Colombia, after water and sanitation services were contracted out in 1993, water supply coverage increased from 68 to

BOX 3.7 Rewarding schools for MDG outcomes

The Learning Guaranty Program, launched in 2002 by the government of Karnataka, India, in collaboration with the Azim Premji Foundation, aims to strengthen incentives for schools to enroll all children and ensure that they learn. All of the approximately 10,000 public primary schools in the poor, northeastern districts of the state are eligible to participate in the program, which is essentially a competition. Using a novel approach, the program rewards schools on the basis of learning outcomes for all children in their catchment area, whether or not they are enrolled. If 60 percent of children can demonstrate on assessment tests that they have acquired 90 percent of prescribed competencies in mathematics and language, the school receives 5,000 rupees. If 70 percent of children do well, the reward is 10,000 rupees. And with 80 percent, the reward is 20,000 rupees. Over a three-year period a school can win a maximum of 60,000 rupees.

In the program's first year, about 10 percent of schools competed, but the number has since risen dramatically. The program provides direct financial incentives for government schools to deliver better education services to their communities. It is expected that the program will enable parents and communities to put pressure on their children's schools to become a certified Learning Guaranty School. It is also expected that such schools will develop more creative ways of encouraging children to enroll and stay in school. The Learning Guaranty Program is an interesting attempt to more closely align schools' incentives and MDG outcomes.

Source: Azim Premji Foundation 2002, cited in World Bank 2004b.

99 percent by 2002, and sanitation coverage increased from 54 to 96 percent. In addition, unaccounted-for water fell, taps began functioning 24 hours a day, and response times for consumer complaints improved dramatically. Poor consumers benefited most from the increased efficiency: more than 80 percent of new connections were in low-income neighborhoods.

After Argentina privatized local water companies in about 30 percent of its municipalities in the early 1990s, child mortality fell by 5–7 percent in those areas. The largest gains occurred in the poorest municipalities, where child mortality fell by 24 percent. Researchers estimate that privatization of water services has prevented 375 child deaths a year.⁶⁶ Data from Bolivia and Chile confirm this pattern: private companies' capacity to generate income from efficiently operated services and promote faster system expansion led to poorer expansion of water supply, with 25–30 percent of network expansion targeted to the poorest fifth of the income distribution.

Countries can capitalize on what private providers do best by allowing high-quality

for-profit providers to serve the top segments of the income distribution and making strategic use of contracting with for-profit and NGO providers to serve other income groups. NGO providers are often associated with local innovation and community involvement in service delivery, which increase quality, targeting, and cost-effectiveness. El Salvador, Guatemala, Honduras, and Panama are increasingly contracting with NGOs to provide health services to remote (often indigenous) populations on the basis of fixed annual capitation payments. In most cases the NGOs use networks of itinerant teams, complemented by community-based paramedics. In Guatemala, where the experience is longest, about 90 NGOs serve more than 3 million people—30 percent of the national population. Impact evaluations have shown more cost-effective health outcomes under this approach than under traditional public sector delivery.⁶⁷

That Bangladesh has made faster progress on MDG outcomes than other South Asian countries, despite its lower per capita income, is attributed by many observers to its wide-

spread use of partnerships between the government and innovative NGOs. In health the country's largest NGO, BRAC, developed a system for teaching mothers how to use oral rehydration therapy for children with diarrhea, under which more than half of outreach workers' compensation is paid as bonuses. Bonuses are based on sample surveys of mothers, and the greater the number of women in a village who can explain how to make and use the rehydration solution, the higher the payment. Within the first two years of the program, two-thirds of mothers sampled could use the therapy—a much higher success rate than outreach and communication efforts usually achieve. Researchers also observed a wide range of practical and effective teaching techniques developed by the outreach workers in response to what worked best for clients.⁶⁸

But private service delivery does not automatically lead to better accountability. Also in Bangladesh, researchers have found higher rates of teacher absence in privately run, government-subsidized secondary schools than in schools run by the government directly. Even though continued public funding is supposed to be tied to school performance, government supervisors rarely visit schools, and there are few institutional mechanisms to ensure accountability.⁶⁹ The issue is not public or private; it is the degree to which the institutional framework creates incentives for good performance and the capacity to hold providers accountable.

Strengthening “Client Power”

In many settings slow progress toward the MDGs mainly reflects the failure of services to reach or meet the needs of poor people. Poor regions are the last to receive access to social services. And even when they do, deep social inequalities and rampant illiteracy can produce such imbalances in client-provider relationships that abusive or alcoholic teachers, nurses hitting mothers during childbirth, and doctors refusing to treat patients of a lower caste constitute “service delivery” for

hundreds of millions of poor people. Even more widespread is the failure to listen to low-income clients' needs in order to make services work better.

Countries are experimenting with ways to strengthen client power in frontline relationships, and the results are encouraging. While increasing client choice among providers is a core strategy, it is most feasible in relatively developed settings—urban areas in middle-income countries—where provider density is relatively high. Approaches that increase voice appear to hold more promise for expanding MDG-related services in low-income countries, at least for the near future.

INVOLVE COMMUNITIES IN TARGETING, MONITORING, AND MANAGEMENT

Experiences with community-run schools, health clinics, and rural water systems in a diverse group of countries suggest that direct client involvement in the design and management of services can yield positive results. The water supply and sanitation sector has been at the fore of more efficient targeting of subsidies by involving communities—and especially women—in designating which households qualify as poor. In Cambodia water operators compete for contracts to connect designated households and are paid per connection; this “output-based aid” has resulted in connection costs for poor households that are about one-quarter below the average for public bids. After being connected, households pay the full costs of operating and maintaining the systems—which ensures their sustainability.

In education, evaluations in numerous Latin American countries and Indian states have found that parental and community involvement in schools is correlated with lower teacher absenteeism, higher student test scores, and in some cases lower dropout and repetition rates. Three Central American countries—El Salvador, Honduras, and Nicaragua—have more than a decade of experience with relatively strong devolution of autonomy to primary schools and substantive

engagement of parents in school management, including the ability to hire and fire principals and teachers. These reforms have resulted in less teacher absenteeism, longer teacher work hours, more homework assignments, and closer parent-teacher relationships. Such changes are promising, especially in contexts where education quality is low, teacher absenteeism is high, and schools are often not functioning.⁷⁰

But evaluations in these countries have also shown that the degree of effective control varies across schools. Although El Salvador's community-managed schools program (EDUCO) has shown that illiterate parents can manage school budgets and key personnel decisions, researchers in Nicaragua found many schools where parents' *de jure* involvement in school councils was not matched by *de facto* voice. Communities often need capacity building and support in taking on these new functions. Finally, evaluations of student learning outcomes provide a reminder that improving teacher attendance and work hours are only first steps toward improving education quality. The impact of school-based management on learning outcomes is mixed, with Honduras showing the most improvement, El Salvador some improvement, and Nicaragua declines. For better outcomes, teachers also need to be knowledgeable in the subjects they are teaching and to use effective teaching methods. School-based management has not affected these areas.

LET CITIZENS EVALUATE PROVIDERS

A second tool for promoting voice is citizen report cards or other surveys to gain client feedback on the performance of public services. Report cards enable clients to signal needed reforms and can increase accountability pressures through media coverage and civil society advocacy. Report cards on public services were first tried in Bangalore, India, in 1993. The feedback—revealing poor quality, petty corruption, lack of access for slum dwellers, and the large hidden private coping costs of deceptively cheap public services—were widely publicized by an active press.

The report cards empowered citizens to directly evaluate the civil service and pushed managers of public agencies to act.⁷¹ By 1999 a report card rated some Bangalore services substantially higher. Citizen report cards have since been used in Colombia (where a program called *Como Vamos* is supported by major media groups that disseminate results), Peru (where they are built into the national household survey), the Philippines, Vietnam, and most recently Albania. They are also being developed in Argentina, Bolivia, Ecuador, Honduras, Mexico, and Ukraine. A similar tool is community scorecards, which focus on service performance at the facility or community level. Rwanda is developing community scorecards for health and education facilities. In Parana, Brazil, a school report card allows parents to rate their children's schools, teachers, and overall performance.

These approaches have the potential to alter accountability relationships between clients and providers, but in many settings it will take time for client power to develop. In Parana state officials observed that parents were often unsure about what to assess and found it difficult—particularly in face-to-face meetings—to criticize the school establishment. Still, as a signal from the public sector that citizens' views are considered important for improving the quality of service delivery and the accountability of providers, these approaches are an important step in the right direction. Their effectiveness will be enhanced if communities have regular access to basic information on school, clinic, district, and national performance on key MDG and other indicators.

STRENGTHEN DEMAND WITH CONDITIONAL CASH TRANSFERS

Conditional cash transfers provide cash grants directly to poor families, conditional on their children's regular school attendance and health clinic visits for immunizations, nutrition support, and growth monitoring. They have been adopted in a number of Latin American countries over the past 10 years and are spreading to other regions.

Such transfers have a number of selling points. First, rigorous impact evaluations have shown that they work—they are effective both in raising the immediate incomes of poor families and developing their longer-term human capital.⁷² Second, conditional cash transfers have political advantages: They allow central governments to have a direct relationship with a target population and to provide a visible and popular form of assistance. The programs can operate with small technical teams, focused on designing and maintaining the targeting system and ensuring timely payments by post or local bank accounts to large numbers of families. Compared with the alternative of channeling incremental public funds through inefficient public agencies or decentralized levels of government, the political attraction for national politicians is clear.

But from the standpoint of MDG progress, conditional cash transfers' third asset is by far the most important. They can protect the health and brain development of children during the period when these investments are most crucial—the first three years of life. Losses in brain development from undernutrition, micronutrient deficiencies, illness, and lack of cognitive stimulation in this period are irreversible. Investments supported by conditional cash transfers in early child development are the most highly leveraged investments countries can make toward MDG progress.⁷³ They affect nutrition, infant and child mortality, and subsequent performance in primary school.

The evidence from Latin America is robust that conditional cash transfer programs increase clients' use of education, health, and nutrition services. Some researchers also point to empowerment effects on poor clients, who gain a sense of legitimacy in approaching public services because the transfers rest on an explicit expectation that they should use such services. A major question in adapting such transfers to other countries is how efficient they are in settings where service quality is poor. Conditional transfers cannot fix the supply side of service delivery. But where supply is adequate, they are an effective tool for stimulating demand among target vulnerable groups.

Quick Wins Are Not Enough

Many developing countries must promote MDG progress as rapidly and cost-effectively as they can over the coming years. There is understandable interest in interventions that produce results quickly—such as insecticide-treated bednets and the elimination of school fees. But there are some important cautions. First, even “quick” interventions require system capacity to deliver, and it is crucial that capacity be built in efficient and sustainable ways. In pursuit of faster progress, donors have too often succumbed to the temptation to “parachute in” capacity or develop parallel delivery channels that may not be sustainable over the long term. Even the quickest of wins needs to be part of a long-term process of capacity building.

Deworming pills, for example, work very quickly, but it has taken four years—after funding became available—to get deworming mainstreamed across primary schools in Guinea and Senegal. Water and sanitation access for clinics and schools can bring vital gains in their effectiveness, but while the physical access may be relatively easy to achieve, the capacity to operate and maintain the hardware is not: Witness the large number of non-functioning school toilets in developing countries. “Quick wins” are not necessarily quick or easy to implement at scale. And even harder and longer-term is building the capacity and systems to sustain them.

Second, some powerful and cost-effective interventions may have longer-term impacts, such as conditional cash transfers that stimulate early child nutrition and health care, or the building of a new medical school. The key for any country is to prioritize investments that will have the highest overall returns in its context. This needs to emerge from a careful diagnosis of the national context, through the poverty reduction strategy process, supported by sound sector planning, costing, and identification of binding constraints.

Still, the “quick wins” recommended by the Millennium Project offer a useful menu for countries to consider. Most of the recommended

interventions are backed by robust microlevel research. Some will be relevant in a number of different country contexts.

But they will not be enough. Quick wins are no substitute for context-specific identification of priorities. Nor do they constitute the full range of high-return investments in a given context, some of which are inherently longer term. Finally, even where they are adopted as relevant strategies, they do not solve the biggest challenge: building capacity for effective, large-scale implementation.

Priorities for Global Action

For many countries, especially in Sub-Saharan Africa, the MDGs will not be met without unprecedented expansion of health and education service delivery. The private sector will play an important role, particularly in health, but most incremental funding will be channeled through the public sector—and in many countries deep changes in public sector functioning are needed for funding to produce results. The challenge is great, but pragmatic strategies are being shown to work.

As discussed elsewhere in this report, the priorities for public action in education, health, water supply, and sanitation must be determined in the context of a country-owned poverty reduction strategy that is at the center of national planning and budgeting processes. If the MDGs are to be reached, poverty reduction strategies must include well-costed, coherent sector strategies aimed at these goals—which has not always been the case. Individual interventions—such as “quick wins”—need to be evaluated in this country-specific framework. To cope with uncertainties in aid levels, countries can draw on sector plans to prepare two or three alternative “stretch” scenarios that can be implemented if additional funding is available.

Special actions are needed in the three critical areas analyzed in this chapter: scaling up skilled providers in health and education, ensuring the sustained financing required to expand these recurrent cost intensive services, and making sure that money produces effective service delivery and results.

Scaling Up Skilled Providers

Expanding education and health services on the scale needed to achieve the MDGs will require major increases in teachers, doctors, nurses, and community health workers, especially in Sub-Saharan Africa. Human resource shortages are likely to be a binding constraint on system expansion, especially in health, unless countries adapt policies and increase provider productivity. Strategies that are proving effective include:

- Pragmatic adjustments to recruitment standards, to increase production of alternative teachers and community health workers.
- Careful deployment and management of providers, to avoid underutilization.
- Effective use of incentives to make public sector positions attractive, especially in rural areas.
- Selective salary adjustments for the highest-skilled workers (such as doctors) in the public sector, to diminish migration.
- Cost-effective investments in medical, nursing, and teacher training capacity, to complement the shorter-term strategies above.

Donors have an important role to play in addressing the crisis in human resources for health in many developing countries. Health sector wage adjustments in OECD countries could attract more of their own nationals into service. Developed countries that benefit from African-trained medical personnel could help finance expanded training facilities in those countries and assist them in recouping medical students' loans. A donor working group has begun to develop proposals in this area, which should get priority attention.

Mobilizing Sustained Recurrent Cost Financing

To achieve the MDGs, many developing countries will need to allocate more of their own fiscal resources to education and health. For education, 20 percent of the recurrent budget is the benchmark under the Fast Track Initia-

tive, while Sub-Saharan African countries, for example, currently average 15 percent. For health, African governments have set a target of 15 percent of the recurrent budget, well above their current average of 8 percent.

But every MDG analysis has concluded that countries' own efforts will not be enough, and a large increase in external financing is required. Equally or more important for the human development MDGs are deep changes in the nature of donor support. A significant share of bilateral assistance falls outside national planning and budgeting processes. Transaction costs severely strain recipient countries' limited administrative capacity. And there is a near-complete disconnect between the type of expenditure needed to scale up service delivery in education and health—recurrent, local, largely personnel costs—and what bilateral donors are actually providing—short-term, in-kind, and largely technical assistance financing.

Most MDG cost estimates have focused on countries' core financing requirements, but most aid today—bilateral and multilateral—cannot be flexibly used for these. Support for capacity building is important, but it must be costed over and above the core requirements. Technical assistance should also be carried out in new ways, to eliminate the all too common pattern of uncoordinated and overlapping studies, training, and technical advisers being provided to the same country by different donors.

The MDGs will not be achieved unless all development partners rethink the way they do business. Specific priority actions include:

- *Aligning aid with PRS priorities.* All aid should support priorities identified in the poverty reduction strategy and endorsed sector plans—nothing should be “off plan.” In countries meeting public expenditure management standards, all aid should flow through national budget and procurement systems.
- *Limiting the number of recipient countries.* A twofold strategy of narrowing the number of countries of bilateral interest and channeling future increases in ODA

largely through multilateral channels and coordinated global efforts would lower transaction costs and contribute to MDG progress.

- *Harmonizing assistance.* At the recent Paris Forum, donors committed to specific harmonization indicators, with progress to be monitored by the OECD's Development Assistance Committee. But the EFA FTI, which involves both country-level coordination groups and regular global meetings to monitor progress, and the High Level Forum in Health and country level coordination groups offer ready-made channels for disseminating the indicators and working within the respective sectors toward better harmonization and alignment.
- *Creating a stable funding framework for the Fast Track Initiative.* To strengthen the Fast Track Initiative, its partners should make a monitorable, public commitment to sustained funding for primary education. The target should be a significant annual increase from each partner's 2005 base, which the initiative's secretariat should monitor. This kind of predictable funding framework is essential to signal to actual and potential recipient countries that the initiative has sustained financial backing. Each partner's annual funding commitment should help fill agreed financing gaps for endorsed countries where they have a bilateral presence or interest; any residual should be allocated to the FTI Catalytic Fund. Donors should also show that expanded support for primary education is not coming at the expense of funding for other levels of education, especially secondary education.
- *Supporting increased funding for health.* Additional external resources are needed to prevent and treat childhood diseases and maternal conditions, sustain HIV/AIDS treatment, and make progress against malaria and tuberculosis. Increased donor funding must be longer-term and more predictable, aligned with country priorities, and increasingly made available through budget support.

- *Aligning global health initiatives with national policies and priorities.* The global health community urgently needs to examine all options for ensuring that global programs organized around specific health priorities do not undermine the coherence of countries' health strategies, the balanced allocation of resources, and the strengthening of health systems. Scenarios should preserve the mandates these programs currently have for resource mobilization, awareness raising, results monitoring, and financing of global public goods with respect to individual disease priorities. But these functions must be much better coordinated at the global level, to achieve greater convergence of policies and strategies, and especially at the country level, with harmonized procurement, disbursement, and reporting.

Each country should have a country-led health sector working group involving all development partners—including the national HIV/AIDS coordinator and a representative from the education sector—to coordinate school health and prevention programs. This group should agree on the overall sector strategy and medium-term investment plan for health, and on key outcome and intermediate indicators to be monitored annually. The most efficient strategy is to create a single pooled fund to provide budget support linked to implementation of the agreed sector program. Within such a framework, global programs could pursue the same objectives—but without the high transaction costs of separate programming missions and procurement and reporting requirements.

The High Level Forum for the Health MDGs, established in 2003, offers a platform for this collaborative “rethink” of the current global architecture in health and for the development of common principles and standards of good practice for the engagement of global health partnerships at the country level.

- *Aiding countries to absorb more aid effectively.* The IMF should continue to take a

public, proactive stance in helping governments increase absorption of external grants linked to the MDGs. IMF policy is that program ceilings should be flexible in accommodating such additional spending when grant financing is available. The IMF should help country authorities work with development partners and civil society groups to clarify how fiscal and wage bill ceilings are derived, and provide reassurance that program ceilings are in fact flexibly accommodating spending supported by grants. Staff reports should also explicitly discuss how IMF-supported programs have addressed key macroeconomic issues that affect MDG progress.

Translating Resources into Service Delivery and Results

Achievement of the MDGs is in the hands of developing countries. Increased aid—especially in the form of flexible budget support—is unlikely to materialize unless countries demonstrate both sound public expenditure management and MDG results. The first requires systems for budget formulation, allocation, and reporting that meet threshold standards of integrity and efficiency. In many of the countries in greatest need of external recurrent cost support, these systems are too weak to give donors confidence that resources can be tracked and used well. Donors are giving high priority to capacity building in this area, but the deepest constraints to country progress are political.

The second requires the capacity for real-time data on MDG progress. Countries need to be able to track the primary completion rate and use regular household surveys and sentinel monitoring to generate data on child and maternal mortality and major communicable diseases. Data must be disaggregated by gender, region, and income to ensure that MDG progress is reaching vulnerable groups. Because outcome indicators improve relatively slowly, intermediate indicators of progress are also important—above all, measures of system

efficiency, such as those for education developed by the Fast Track Initiative. A similar framework is being developed by a donor consortium in health (Health Metrics Network). These new approaches will work to the advantage of countries demonstrating improved performance.

Progress will also require a better evidence base for policy, built on rigorous impact evaluation of key programs. Programs should be rolled out in ways that permit the use of control groups. Countries should develop local capacity for carrying out quality evaluations and using results. But knowledge on how interventions play out under different country circumstances is a global public good—and the costs of generating it need to be broadly shared by the international development community. The World Bank has an important role to play, through the Development Impact Evaluation initiative, in organizing more—and more systematic—evaluation of innovative programs across countries, supporting metastudies in key areas, ensuring broad diffusion and use of results, and supporting country-level capacity building.

Ultimately, strengthening service delivery requires action to improve core accountability relationships: the responsiveness of governments to citizen demands through the political process, the responsiveness of service providers to clients, and the effectiveness of government agencies in turning resources into results. These weaknesses are the deepest threat to MDG progress. There are no panaceas. But countries are making progress in improving governance. Sector management can be helped by clear funding norms, competency-based recruitment, results focus, attention to cost-effective standards, and strategies to make effective use of the private sector. Above all, governments can strengthen the voice of clients at the point of service delivery—through the power of information, direct involvement in school and health facility monitoring and management, and the use of conditional cash transfers.

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Realizing the Development Promise of Trade

Removing barriers to trade that discriminate against developing countries is potentially a powerful tool to help achieve the Millennium Development Goals (MDGs). Multilateral, reciprocal, nondiscriminatory trade liberalization offers the best approach for supporting development. Rapid conclusion of an ambitious Doha Round is therefore of great importance. As noted in *Global Monitoring Report 2004*, the round should spawn a major reduction in trade-distorting policies. Ambitious reference points could be helpful in guiding the negotiations, such as capping the agricultural tariffs of developed countries at 10 percent, eliminating their agricultural export subsidies and manufacturing tariffs, fully decoupling domestic agricultural and rural support policies from production, and pursuing meaningful liberalization of trade and investment in services, including through temporary migration of service providers. Equally important, developing countries need to set ambitious targets to further reduce the average level and dispersion of protection and substantially expand their World Trade Organization (WTO) commitments. To assist in attaining the MDGs, such actions should be fully implemented by 2015, with significant progress before 2010.

A surge in ambition is needed to realize the promise of the Doha Development Agenda. The ambition must focus on transforming

agricultural trade policies in OECD countries, devoting greater attention to reducing the trade-restricting effects of nontariff measures, and safeguarding and expanding the scope for developing countries to contest services markets. Given that trade restrictions are much higher in developing than developed countries, significant further liberalization by developing countries will also be required to realize the full potential of trade for development. Indeed, about half of the potential developing country gains from merchandise trade reform will come from reforms by developing economies.

An ambitious Doha Round would benefit the world as a whole and developing countries as a group. But it would not be a panacea, and it would not be costless. Trade is a key driver of growth, but it needs to be complemented by many other policies. In many developing countries “behind-the-border” policies and the investment climate are binding constraints on the ability to realize the benefits from greater trade opportunities. All countries will incur adjustment costs from deep trade reforms, and some developing countries will confront erosion of current tariff preferences. Such changes should be considered within the broader context of development and poverty reduction strategies, with special attention to the concerns of poor households. The standard argument for trade liberalization is that total gains exceed total losses—especially over

time—and that gainers can compensate losers while still improving their welfare. But in practice such compensation does not occur. An ambitious Doha Round would generate substantial gains, providing a basis for transferring additional resources to low-income countries to enhance trade capacity. Given that lack of competitiveness due to high operating costs and weak investment climates is the primary factor limiting trade potential in many poor countries, actions to lower such costs are urgently needed, especially in Africa. The agenda includes supporting trade logistics and facilitation, strengthening transport infrastructure, and further reforming policies that create antiexport bias—including import tariffs.

An ambitious Doha outcome—significant liberalization commitments by both developed and developing countries—complemented by a credible commitment to convert part of the resulting gains into increased aid to the poorest countries to enhance their trade capacity—would send a strong signal that political will exists to leverage trade to help achieve the MDGs. This would help countries that have the capacity to export but are now constrained (such as middle-income agricultural exporters) as well as countries that have much less capacity and are unlikely to benefit much from the standard reciprocal exchange of market access commitments in the WTO.

Recent policy in OECD countries has emphasized tariff preferences for small, low-income countries, especially the least developed countries (LDCs) and Sub-Saharan African countries. While actions to make tariff preferences more effective in the short run could be beneficial—for example, through adoption of common, liberal rules of origin—consideration should be given to alternative forms of trade assistance that generate greater benefits for recipients and are less trade-distorting. Tariff preferences have been of limited value to many African countries and have negative effects on the functioning of the global trading system. Alternative measures include sharp reductions in most favored nation (MFN) tariffs and other barriers by high- and middle-income countries on goods

and services of export interest to low-income countries, financial assistance, and actions to minimize the incidence of nontariff measures on exports from low-income countries.

“Aid for trade”—assistance to bolster trade capacity and reduce trade costs—can have high returns in terms of increasing growth, reducing poverty, and facilitating the realization of ambitious global trade reforms. The share of aid for trade in total aid commitments increased from 3.6 percent in 2002 to 4.2 percent in 2003.¹ A concerted effort to further expand such assistance could do much to improve developing countries’ capacity to benefit from both global and domestic reforms. Numerous trade integration studies undertaken for the LDCs under the Integrated Framework for Trade-Related Technical Assistance, as well as similar analyses done in other developing countries, have identified areas where such aid can be used effectively. The Integrated Framework, a collaborative venture between six multilateral agencies, bilateral donors, and governments of LDCs, offers a mechanism to identify priorities and allocate additional assistance to trade-related investments and policy reforms. To date, dedicated resources to support implementation of the framework have been limited to small-scale technical assistance. Funding for trade priorities is considered in the context of the resource allocation and prioritization process related to country development strategies—poverty reduction strategies (PRSs) or equivalent national development strategies—with donor assistance complemented by loans and other support from international financial institutions. While this should continue to be the case, the Integrated Framework could be used more extensively to both bolster the trade capacity of poor countries and help address the adjustment costs from an ambitious Doha Round.

Regional cooperation is another potentially powerful instrument to leverage trade for development—as long as it does not detract from the pursuit of an ambitious Doha Round and focuses policy attention on domestic (intraregional) policy-related trade constraints.

In Sub-Saharan Africa there is a strong regional dimension to growth, absorptive capacity, and the widening of economies of scale needed to lower infrastructure costs and facilitate trade. To fully realize the development promise of both North-South and South-South regional integration arrangements, developing country members of trade agreements should implement significant liberalization on a nondiscriminatory basis in addition to granting preferential access to partner countries. Many Sub-Saharan countries still rely on import duties for a significant portion of government receipts, so revenue concerns and the ability to put in place alternative revenue sources are factors that need to be taken into account in determining the speed of liberalization.

Trade Performance of Low-Income and Least Developed Countries

The past two decades saw a boom in world trade. Non-oil exports from developing countries grew faster than those from developed countries (table 4.1), and their global market share rose from 21 percent in 1980 to 37 percent in 2003 (table 4.2). This increase reflects the growing openness of developing countries to trade and the competitiveness of their exports in global markets. Openness ratios (the sum of exports and imports as a share of GDP) have increased for most developing regions and range from a low of 25 percent in South Asia to 64 percent in Europe and Central Asia.

The foreign exchange earnings of the poorest countries depend on agricultural commodities and labor-intensive manufactures. Although its average annual export growth has increased since the mid-1990s, Sub-Saharan Africa's share of world trade remains far below what prevailed in the 1970s (see table 4.2). Reasons include the region's high dependence on agriculture, limited trade opportunities caused by highly distorting policies in OECD countries, and downward global price trends for some commodities (such as coffee) due to expanding supplies.

Problems on the supply side of the market also help explain the below-average trade and

TABLE 4.1 Trade has grown rapidly in recent years, especially in developing countries (average annual growth rate, percent)

Country group	1991–95	1996–2000	2001–03
Exports			
World	8.7	4.8	5.8
Developing countries	12.2	7.7	7.4
Least developed countries	3.8	10.1	8.4
African least developed countries	0.1	7.3	10.2
Low-income countries	8.7	9.6	8.1
African low-income countries	2.8	12.6	4.2
Imports			
World	8.1	5.2	6.0
Developing countries	13.3	5.3	8.1
Least developed countries	5.8	3.3	12.0
African least developed countries	3.1	1.9	13.3
Low-income countries	9.2	4.4	12.8
African low-income countries	5.2	0.9	16.1

Source: IMF, Direction of Trade Statistics.

TABLE 4.2 Developing countries account for a growing share of non-oil exports (percentage of total)

Country group	1975	1980	1990	1995	2000	2003
Developed countries	80.3	78.9	76.5	70.6	65.1	62.6
Developing countries	19.7	21.1	23.5	29.4	34.9	37.4
Least developed countries	0.8	0.6	0.6	0.4	0.5	0.6
African least developed countries	0.6	0.4	0.4	0.2	0.3	0.3
Low-income countries	3.1	1.7	2.0	1.9	2.3	2.5
African low-income countries	2.1	0.8	1.0	0.7	0.9	0.9

Source: IMF, Direction of Trade Statistics.

foreign direct investment performance of many low-income countries. Civil conflicts have undermined economic performance in a score of African countries, and in others poor macroeconomic policies have often led to price disadvantages as a result of overvalued currencies.² Moreover, governance problems, corruption, and institutional weaknesses have worsened the local investment climate and inhibited local entrepreneurs from taking advantage of market opportunities. Those

same factors have also induced instability in commodity prices and had adverse effects on the demand for commodity exports.

Since the mid-1990s exports from low-income countries and the LDCs have grown faster than the average for the world and for developing countries (see table 4.1). This largely reflects an increase in commodity prices and more recently the decline in the U.S. dollar, as well as an increase in exports of manufactures (textiles). These developments contributed to a minor recovery in these countries' world market shares, though these remain below those of the 1970s (see table 4.2). Global export shares for low-income African countries and for the LDCs as a group exceed their shares in world GDP.³ Average import growth rates have also picked up recently for low-income countries and the LDCs, outpacing growth in imports for the world and for developing countries during 2001–3.

Exports from the poorest countries remain concentrated in primary commodities. In 2001 the concentration index of Sub-Saharan Africa's exports was 0.47—similar to that of the Middle East and North Africa, a region

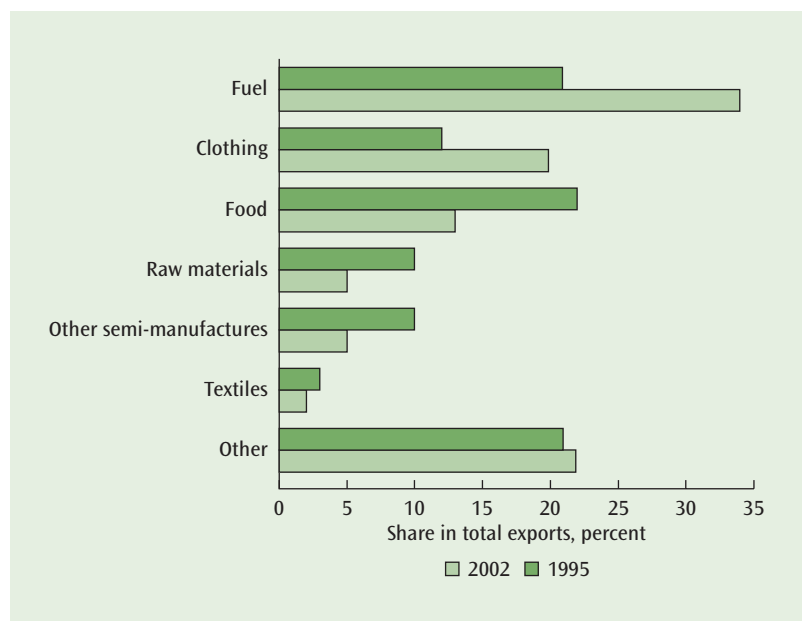
heavily dependent on oil exports.⁴ This is almost twice the figure for East and South Asia, and 50 percent higher than in Latin America. Agricultural products account for at least a quarter of exports from Sub-Saharan Africa and Latin America. As a result countries in both regions are subject to greater commodity price (terms of trade) volatility. The decline in nonfuel commodity prices and the increase in energy prices since 1995 have contributed to a decline in the shares of food and raw materials and an increase in the share of fuels in exports from the LDCs (figure 4.1). Expanding apparel exports from Africa are a noteworthy development of recent years. While reliable data on the composition of exports for 2003 are not yet available, the sharp increase in fuel prices during 2003–4 will likely further increase the share of fuels in LDC exports.

Recent Developments in Trade Policy

Global trade policy developments in 2004 provide a mixed picture. After a disappointing outcome at the WTO ministerial conference in Cancun, Mexico, in September 2003, there was considerable gloom about the prospects of the multilateral trading system. But in 2004 WTO negotiations came back on track, with a package of agreements reached in August. The WTO agreed on a framework for negotiations on agriculture and industrial products, a set of recommendations on services, and modalities for negotiating improved customs procedures. Other positive developments included proposals for reforming EU sugar and banana regimes, and an end—after some 40 years—to the regime of managed trade in textiles and clothing.

The proliferation of reciprocal preferential trade arrangements continued in 2004, with activity spread across all regions and countries. Since 1990 the number of preferential trade arrangements in force and noti-

FIGURE 4.1 LDC Exports: Less food and raw materials, more energy and apparel



Source: WTO (2004).

fied to the WTO has risen from 50 to nearly 230,⁵ and another 60 are being negotiated. But there is growing concern that such arrangements create trade diversion and substantial administrative costs due to complicated rules of origin. Although many of the countries most active on this front are strong proponents of the Doha Round and consider the agreements a form of “competitive liberalization” that reinforces WTO-based liberalization efforts, preferential trade may create interests opposed to multilateral extension of market access opening and divert scarce negotiating resources. Moreover, while the agreements can help developing countries by reinforcing internal reforms and lowering trade costs, such benefits do not require preferential access to markets. As discussed later in this chapter, minimizing discrimination and focusing attention on cooperation to lower regulatory trade barriers is an important challenge from a development perspective.

The recent accession of 10 new members to the European Union consolidated the extensive network of intra-European trade agreements and expanded the EU internal market. The European Union is also pursuing association agreements with Common Market for the Southern Core (Mercosur) and Mediterranean countries, and is negotiating reciprocal economic partnership agreements with regional subsets of African, Caribbean, and Pacific (ACP) countries.

Over the past year the United States has also been active in concluding preferential trade agreements, including with Australia, Bahrain, Central America, the Dominican Republic, and Morocco. Several more are under negotiation. In Latin America, Mercosur signed an agreement with Andean countries and is negotiating with India, Mexico, and South Africa (in addition to the European Union). Mexico has entered into a trade agreement with Japan and is negotiating one with Singapore. Similarly, a South Asia free trade area is being negotiated between seven countries, and in Africa the customs union of the East African Community has been launched. The Association of South-East Asian Nations (ASEAN) has agreed to negotiate preferential agreements

with China, India, and Japan, among others. Japan, the Republic of Korea, Singapore, South Africa, and Thailand have also been negotiating bilateral accords.⁶ The rising regional activity in East Asia is particularly noteworthy given these countries’ historical noninvolvement in preferential trade and reliance on the multilateral trading system. An increasing number of developing countries are seeking membership in regional agreements.

Developments also occurred for nonreciprocal preferences. The European Commission introduced a new Generalized System of Preferences scheme offering duty-free access to the EU market for 80 percent of dutiable tariff lines to countries that adhere to a number of international conventions on human rights, labor, the environment, and governance. The new scheme enters into force in April 2005 and provides for better product coverage, more relaxed rules of origin, and greater certainty and predictability in the granting of preferences. In the United States the passage of the African Growth and Opportunity Acceleration (AGOA III) Act extended the general timeframe for AGOA preferences until 2015. It also extended the third-country fabric manufacturing provision for least developed AGOA beneficiary countries until 2007—an important provision since few AGOA beneficiary countries have adequate capacity to manufacture fabric. The legislation provides temporary respite to textile and clothing sectors in several Sub-Saharan countries (including Lesotho, Madagascar, and Swaziland) as competitive pressures intensify following the elimination of all quantitative export restraints in January 2005.

Tariffs, Nontariff Measures, and Contingent Protection

In recent years there has been a decline in tariff barriers worldwide, reflecting autonomous reform, regional agreements, and WTO accession (including by Cambodia, China, Egypt, India, Iran, Pakistan, Tunisia, and Zimbabwe). Globally, average tariffs fell by 2 percentage points between 1997 and 2000 and by 1 point between 2000 and 2003. As measured by MFN

TABLE 4.3 Applied most favored nation tariffs are highest in South Asia and Sub-Saharan Africa (simple average, percent)

Region/income group	Late 1980s	2004 (preliminary)
East Asia and Pacific	18.8	9.6
Europe and Central Asia	10.2	7.3
Latin America and the Caribbean	22.4	10.4
Middle East and North Africa	17.3	12.4
South Asia	68.9	17.7
Sub-Saharan Africa	25.1	15.3
High-income OECD	7.0	4.1
High-income non-OECD	9.0	6.6
Developing countries	25.4	11.7
Least developed countries	28.4	15.1
Low-income countries	31.7	12.9
Middle-income countries	21.8	10.5

Sources: UNCTAD TRAINS database; World Bank, *World Development Indicators*; IMF Trade Policy Information Database; WTO Trade Policy Reviews.

Note: Classification of regions and income groups based on World Bank 2004b.

TABLE 4.4 Nontariff measures remain high in several regions, 2002 (percent)

Region/income group	Frequency ratio (share of tariff lines)	Coverage ratio (share of imports)
East Asia and Pacific	44.0	32.8
Europe and Central Asia	14.6	23.9
Latin America and the Caribbean	26.9	44.4
Middle East and North Africa	49.5	51.6
South Asia	12.1	28.6
Sub-Saharan Africa	24.4	28.8
High-income OECD	22.0	24.1
High-income non-OECD	45.1	46.9
Developing countries	27.2	34.3
Least developed countries	20.0	36.7
Low-income countries	25.5	36.4
Middle-income countries	28.3	34.0

Sources: UNCTAD TRAINS database; WTO Trade Policy Reviews; EU Product Standards Database; Groupe d'Economie Mondiale, Institut d'Etudes Politiques.

Note: Classification of regions and income groups based on World Bank 2004b. Nontariff measures include price controls, quantity restrictions, state trading monopolies, and technical product regulations as classified in the UNCTAD TRAINS database.

tariffs, South Asia is the most restrictive region, followed by Sub-Saharan Africa (table 4.3).

By contrast, there has been no decline in nontariff measures affecting trade, such as licensing requirements and antidumping investigations. (Licensing requirements are often associated with health- and safety-related regulatory

requirements that apply in principle to both imports and domestic products; see below.) Nontariff measures apply to a large share of trade, with the highest ratios in developing countries (table 4.4). But as discussed below, when converted to ad valorem equivalents, nontariff measures are more important in rich countries.

The use of instruments of contingent protection—antidumping and safeguard actions—against imports by WTO members has grown steadily, with more than 2,400 antidumping investigations launched since 1995 (table 4.5). This instrument is increasingly being used by developing countries against other developing countries. Indeed, developing countries have overtaken developed countries in the number of cases launched: between 2002 and June 2004 developed countries initiated 190 cases, compared with 441 by developing countries. India has passed the United States as the top initiator, and Argentina and South Africa have an even higher incidence of antidumping use relative to the value of their imports (table 4.6).

Another important nontariff measure affecting exports and imports are health- and safety-related product standards. In contrast to antidumping efforts, which by definition are intended to protect domestic import-competing industries, health and safety regulations (mandatory product standards) are often applied equally to domestic and foreign (imported) products—so in principle they are not (or should not be) intended to protect domestic industries. Indeed, WTO rules prohibit the protectionist use of technical product regulations. As discussed below, such norms affect trade by increasing the costs of entering a market, with the incidence of the associated costs differing across countries depending on the composition of their exports and the ease of satisfying (documenting compliance with) a specific norm.

Textiles and Clothing, Bananas, and Sugar

A major trade policy change in 2004 was the phase-out of bilateral quotas on exports of textiles and clothing at the end of the year, as

required by the Uruguay Round Agreement on Textiles and Clothing. Because the quotas were bilateral and not based on competitive considerations, their removal is likely to lead to export declines and balance of payments swings for several countries. China and India are expected to gain from this liberalization, as they are considered the most competitive producers. But the actual effects will depend on market sourcing decisions by retailers and buyers, as well as the extent to which safeguard measures are invoked and U.S. quotas are maintained under the provisions of China's WTO membership. In January 2005 China imposed a low MFN tax—ranging from 2–4 percent—on its textiles and clothing exports, to remain in place through the end of 2007.⁷ Although this will attenuate the expected shift in sourcing to Chinese producers, the elimination of the quotas will still force significant adjustments in less efficient countries (box 4.1).

In July 2004 the European Union announced that it will substantially reduce its sugar production and exports over a four-year period.⁸ The cut in output is to be accompanied by a reduction in domestic support prices of about one-third, implemented over a three-year period. Import quotas from African, Caribbean, and Pacific countries and India will be maintained at current levels. Farm support payments will be decoupled from production and linked to environmental and food safety standards. While this reform will benefit EU consumers and competitive developing country suppliers, it will reduce benefits from sugar production for several African, Caribbean, and Pacific countries as the value of their quotas declines. The European Union has made provisions for adjustment assistance for such countries.

In October 2004 the European Union announced a proposal to change its import regime for bananas. Under a WTO-backed agreement with Ecuador and the United States, the Union is required to move away from its quota-based system of controlling imports to a tariff-only system by January 2006. Under the proposal the Union would levy a tariff of 230 euros a ton on banana imports from non-African, Caribbean, and Pacific countries,

TABLE 4.5 Developing countries initiate more antidumping investigations, 1995–2003

Initiating region	Target region			
	Developed countries	Developing countries	Transition economies	Total
Developed countries	226	574 (129)	132	932
Developing countries	453	827 (225)	173	1,453
Transition economies	4	7 (2)	20	31
Total	683	1,408 (356)	325	2,416
Share of total (percent)				
Developed countries	24.2	61.6 (13.8)	14.2	100.0
Developing countries	31.2	56.9 (15.5)	11.9	100.0
Transition economies	12.9	22.6 (6.5)	64.5	100.0
Total/average	28.3	58.3 (14.7)	13.5	100.0

Source: WTO Antidumping Committee data.

Note: Numbers in parentheses are actions against China. Developed countries are Australia, Canada, EU15, Iceland, Japan, New Zealand, Norway, Switzerland, and United States. Transition economies are Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, FYR Macedonia, Georgia, Hungary, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Moldova, Poland, Romania, Russian Federation, Slovak Republic, Slovenia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan, and Yugoslavia.

TABLE 4.6 A few large developing countries have launched the most antidumping investigations, 1995–2003

Initiating country/region	Number of cases	Share of total (percent)	Index of initiations per US\$ of imports (United States = 100)
India	379	15.7	2,416
United States	329	13.6	100
European Union (15)	274	11.3	101
Argentina	180	7.5	2,577
South Africa	166	6.9	2,634
Australia	163	6.7	719
Canada	122	5.0	170
Brazil	109	4.5	590
Mexico	73	3.0	155
China	72	3.0	109

Sources: WTO Antidumping Committee data; IMF, *Direction of Trade Statistics*.

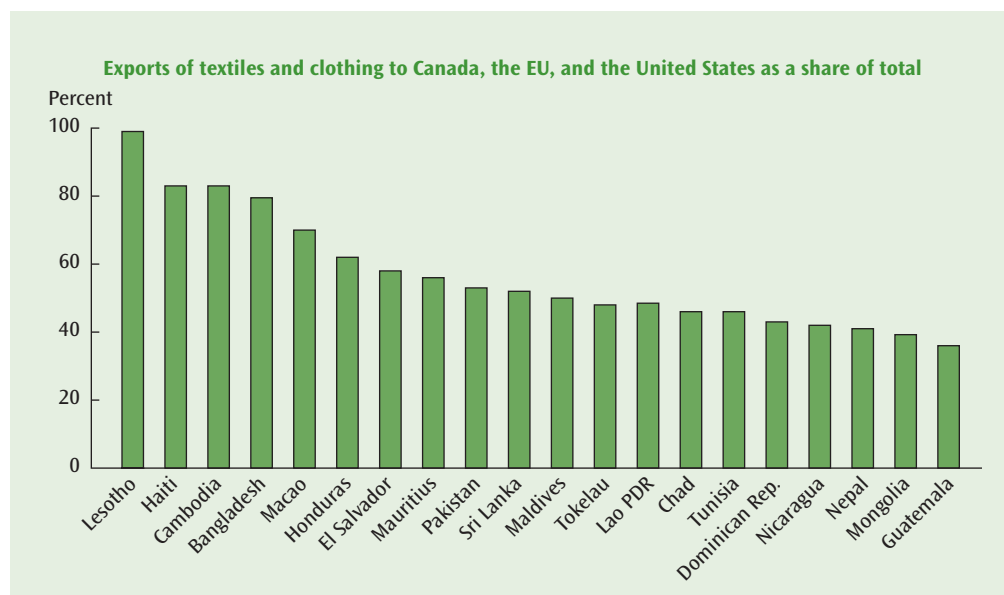
which it argues is equivalent to the level of protection now in place. This move has disappointed producers in several Latin American countries, who are concerned that such a high tariff will make them unable to compete in the EU market, as well as producers in African, Caribbean, and Pacific countries, who fear that the proposed tariff is not high enough to maintain their existing market shares.

BOX 4.1 The varying effects of the Agreement on Textiles and Clothing

The Agreement on Textiles and Clothing, agreed to as part of the Uruguay Round, was designed to progressively phase out quotas that limited developing countries' opportunities to export textiles and clothing. Quotas were to be gradually abolished, and the growth rates of export volumes subject to quotas steadily increased, over a 10-year period ending on 1 January 2005. Importing countries were allowed to choose which products to make quota free at three stages (1995, 1998, and 2002) set out in the agreement. They chose products in which developing countries did not have a comparative advantage—or even face quotas. The acceleration of quota growth did succeed in making quotas nonbinding for some exporters, but for some dynamic exporters—particularly China—the quota growth rates of around 3 percent a year were much lower than their supply capacity. As a result quotas became more restrictive.

Quota abolition will lower prices for consumers in markets that had restricted textile and clothing imports. Prices in unrestricted markets can be expected to rise, absent the incentive for efficient exporters to divert products shut out of U.S. and EU markets into these markets. In addition, less competitive suppliers—including small, low-income countries that became exporters of textiles and clothing in part because dynamic exporters were fettered by quotas—may be confronted with lower prices for their products. The impacts on individual exporters will depend on the destination of their exports. One way to identify countries that might lose from this change is to examine what percentage of their exports comes from exports of textiles and clothing to restricted markets. The 18 most vulnerable countries are those for whom exports of textiles and clothing to Canada, the European Union, and the United States exceeded 35 percent of total exports in 2003 (see figure). Most of these are small economies.

Francois and Spinanger (2004) estimate that for China the quotas had the same effect as a tax of about 25 percent on clothing exports to the European Union and United States. Most other exporters faced much lower barriers. The adverse effect on the prices received by vulnerable exporters would be much smaller than 25 percent, partly because textiles and clothing are differ-



Source: Manole (2004).

entiated products (exports from different countries are very different; see Martin, Manole, and van der Mensbrugghe 2004) and partly because prices in unrestricted markets can be expected to rise following abolition of the quotas.

Continuation of quotas against China is a possibility because of the safeguard provisions included when China acceded to the WTO in 2001 (Bhattasali, Li, and Martin 2004). But these apply only against China: if invoked, they would allow other efficient exporters to fill the gap. A safeguard system—or an equivalent export tax on China's exports—would create global costs of around \$13 billion, while transferring some \$3 billion to competing exporters (Manole 2004). Most of this benefit would go to countries that are not heavily dependent on exports of textiles and clothing to restricted markets.

Initial indications are that exports of many smaller countries dependent on textiles and clothing are holding up better than had been widely feared. This partly reflects reforms to raise productivity in these countries and partly reflects China's reluctance to expand its production of textiles and clothing, rather than more sophisticated products. In addition, as noted by Nordas (2004), standard modeling results do not fully incorporate the special features of the supply chain—particularly the advantages of proximity for geographically favored countries in a marketing environment of just-in-time ordering. Still, this initial assessment should not lead to complacency. Countries dependent on textile and clothing exports and their development partners need to focus on how these countries can raise their productivity and improve their trade policies and investment climates to encourage diversification away from dependence on a single sector.

Restrictiveness and Incidence of Trade Policies

As noted in *Global Monitoring Report 2004*, the trade policy measures reviewed above cannot be readily compared across countries. Such comparison is possible only on the basis of an index that measures the overall trade restrictiveness implied by trade policy. The measure used is the overall trade restrictiveness index (OTRI), which represents the uniform tariff equivalent of the different policy instruments observed for a country that would generate the prevailing level of trade. When the focus is on measuring the trade effects of policies on an importing economy, the trade restrictiveness index can be defined as the equivalent uniform tariff that would keep imports constant. When the focus is on an exporting country's perspective (market access), the index is the equivalent uniform tariff implied by the set of policies maintained by each country (or all importers) on that economy's export bundle. The OTRI is calculated as the weighted sum of nominal tar-

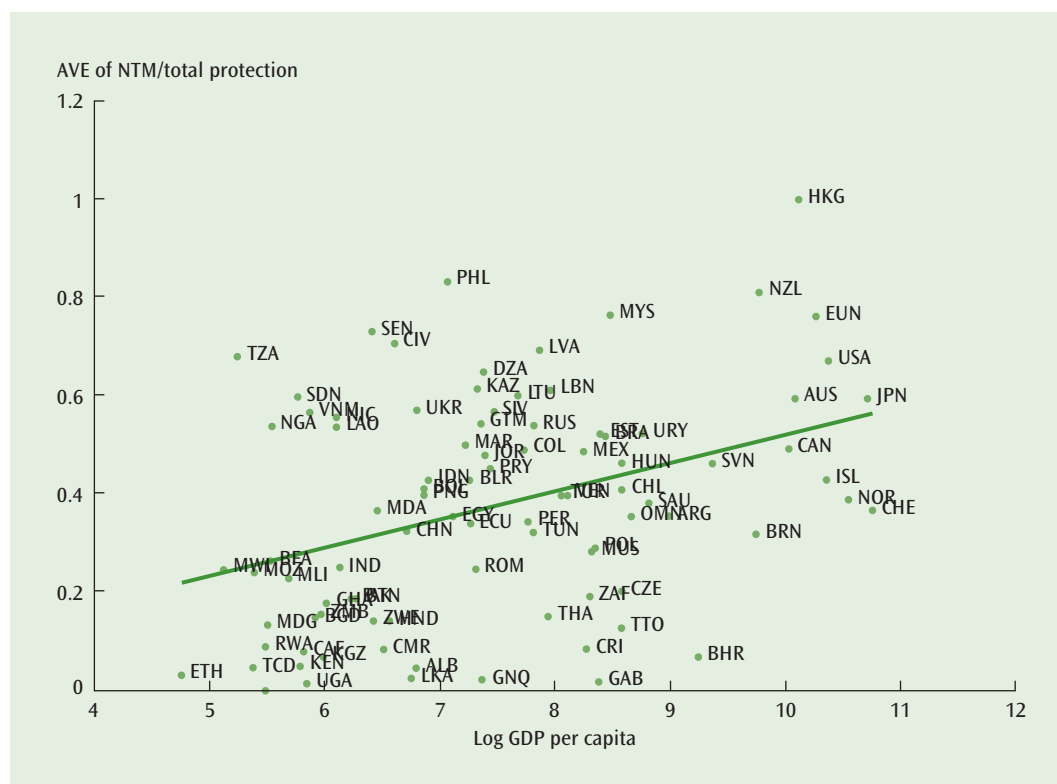
iffs and the ad valorem equivalent of nontariff measures at the tariff line level.⁹

The contribution of nontariff measures to the overall level of trade restrictiveness increases with GDP per capita (figure 4.2). One reason is that average tariffs in rich countries tend to be lower and are bound in the WTO and through regional trade agreements. As a result protectionist pressures, if successful, will by necessity be reflected in other instruments—antidumping being a major example. Most developing countries have tariff bindings (commitments) in the WTO that are well above their applied tariffs, and may not have bound tariffs at all, allowing for the use of tariffs when desired.

Trade Restrictiveness, Income, and Poverty

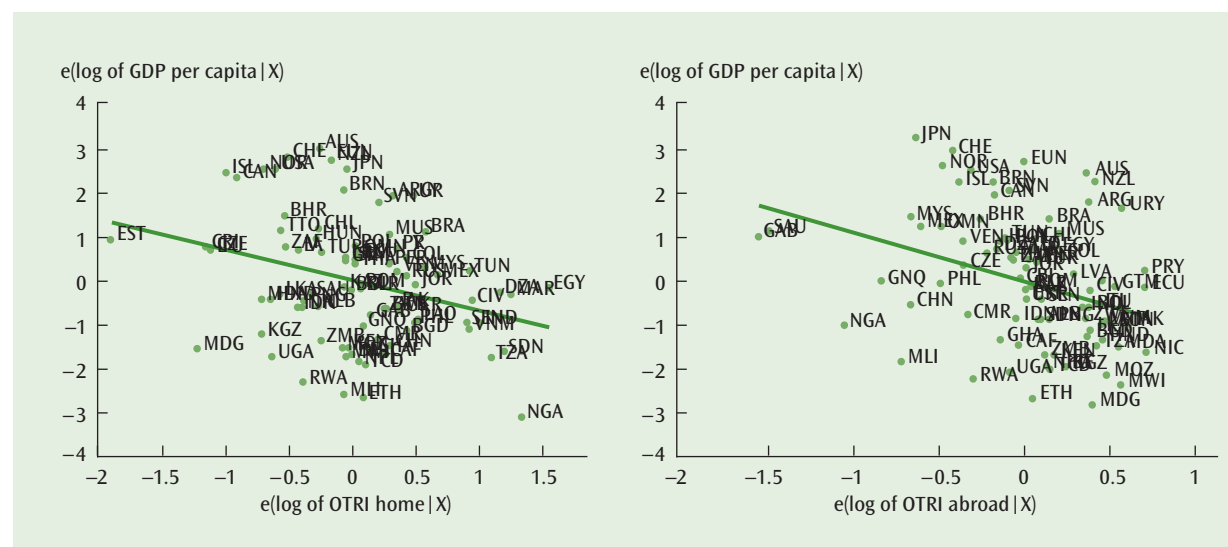
OTRIs are negatively correlated with GDP per capita—the higher is a country's GDP per capita, the lower is its trade restrictiveness as measured by the OTRI (figure 4.3). Similarly, the higher is a country's GDP per capita, the

FIGURE 4.2 Nontariff measures are more important in rich countries, 2002



Source: Kee, Nicita, and Olarreaga 2005b.
Note: AVE stands for ad valorem equivalent.

FIGURE 4.3 Trade restrictiveness at home and abroad falls as countries become richer



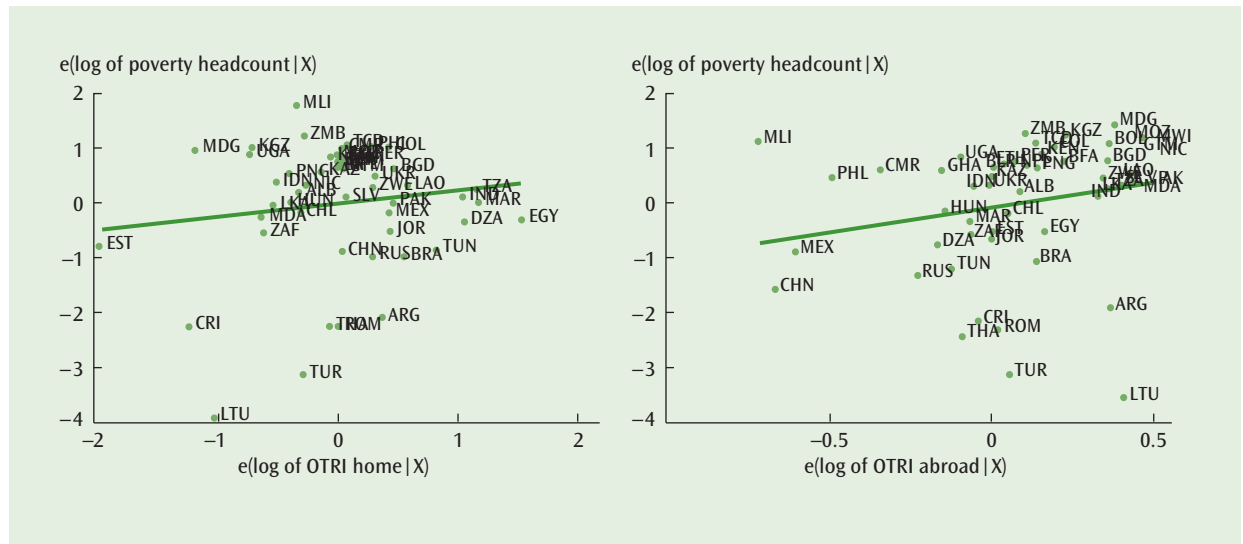
Regression line shown: coefficient = -0.71 ; standard error = 0.23 ; t-statistic = -3.05 .

Source: Kee, Nicita, and Olarreaga 2005c.

Note: Partial correlation plots obtained by regressing log GDP per capita on constant, log OTRI at home, and log OTRI abroad.

Regression line shown: coefficient = -1.16 ; standard error = 0.32 ; t-statistic = -3.52 .

FIGURE 4.4 Trade restrictiveness at home and abroad rises with poverty headcount



Regression line shown: coefficient = 0.24; standard error = 0.25; t-statistic = 0.94.

Source: Kee, Nicita, and Olarreaga 2005c.

Note: Partial correlation plots obtained by regressing log poverty headcount on constant, log OTRI at home, and log OTRI abroad.

Regression line shown: coefficient = 0.91; standard error = 0.52; t-statistic = 1.74.

lower are the trade barriers imposed by the rest of the world on its exports. Thus there is a negative association between GDP per capita and the trade restrictiveness that countries impose on their imports and that imposed by the rest of the world on their exports.

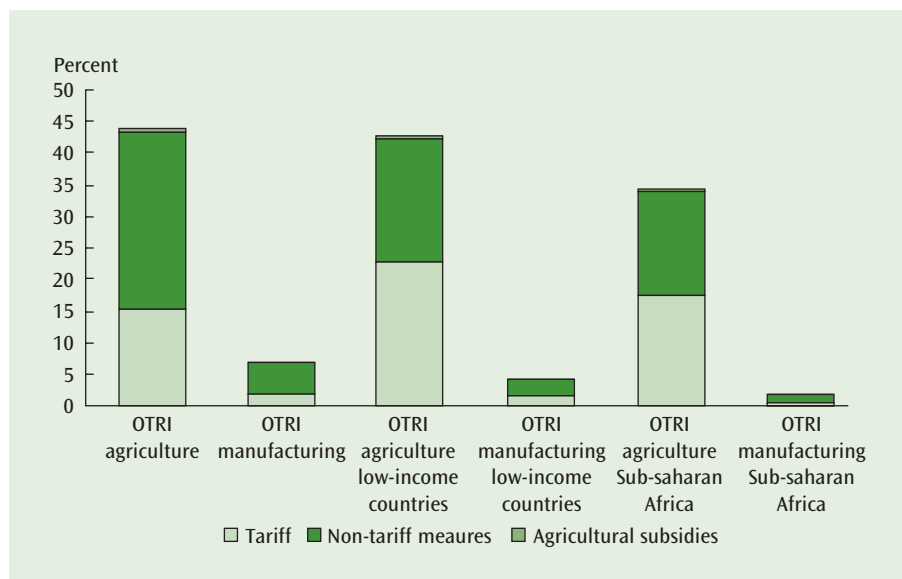
For developing countries for which such data are available, OTRIs are positively correlated with poverty headcounts: the higher is a country's trade restrictiveness, the poorer it tends to be (figure 4.4). Higher trade restrictiveness on exports is also positively correlated with poverty headcounts—that is, the higher is the OTRI confronting a country's exports, the more poor households that country is likely to have.¹⁰ The implication is that reductions in protection at home and abroad are likely to be pro-poor. Although such correlations of average trade restrictiveness and the number of poor people in a country suffer from aggregation bias and do not imply a causal relationship, more detailed microeconomic studies of trade reforms in developing countries find that liberalization tends to benefit poor people.¹¹

The Incidence of OECD Trade Policies

Estimated OTRIs for high-income OECD countries average 12 percent for all trade. They are much higher for agricultural trade than other merchandise—44 percent compared with 6 percent (figure 4.5). This disparity reflects high levels of support for agricultural production: the OECD Producer Support Estimate rose to 32 percent in 2003, up from 31 percent in 2002.¹² A similar sectoral pattern applies to OTRIs for imports from developing countries, although the absolute level of trade restrictiveness is substantially lower for trade with Sub-Saharan Africa as a result of bilateral tariff preference programs (but still high in agriculture).

Nontariff measures account for a large share of these OTRIs.¹³ Thus, taking the effects of such measures into consideration is important in accurately assessing the extent to which policies affect trade, both imports and exports. It is important to bear in mind that not all nontariff measures have explicit protectionist objectives. Particularly in the case of health- and safety-related product standards, the intention generally is not (and

FIGURE 4.5 Agricultural protection is high in OECD countries, and border barriers account for most of it



Source: Kee, Nicita, and Olarreaga 2005c.

should not be) to protect domestic producers. To varying degrees, all countries maintain such regulations. WTO rules on such policies require that they be justified by scientific evidence and a process of risk assessment, and based on international norms if any exist. Such standards should also apply to domestic goods, although WTO case law and numerous bilateral disputes over many years regarding their enforcement illustrate that in practice these standards may be used to shield domestic producers from import competition.¹⁴ However, it is not possible to discern intent in the data—OTRIs simply show that these types of policies have a major effect on trade, especially in agricultural products.¹⁵ No presumptions exist or are implied regarding the intent or scientific basis of any of the nontariff measures captured in OTRIs.¹⁶

Because the OTRI does not include services trade and policies, it likely underestimates countries' actual trade restrictiveness. Trade in services has been growing rapidly for the past two decades and now accounts for some 40 percent of world trade if sales of

foreign affiliates are included.¹⁷ But statistical agencies do not compile the type of detailed data on bilateral trade in services that exist for merchandise. Nor is there a comprehensive global database on services-related trade policies.

The trade policies of high-income OECD countries imply higher restrictions on imports from low-income countries than from other sources (table 4.7). In part this simply reflects the sectoral structure of protection—most intra-OECD trade is in manufactures that confront low barriers. Barriers are highest for agricultural imports from middle-income countries, which do not benefit from the preferences accorded to poorer countries (table 4.8). Still, even after taking into account the fact that developing countries benefit from tariff preferences under the Generalized System of Preferences and that Sub-Saharan Africa and the LDCs have highly preferred—often duty- and quota-free—access to many OECD markets as a result of programs such as the EU Everything But Arms initiative and the U.S. African Growth and Opportunity

TABLE 4.7 OECD trade restrictiveness is highest toward low-income countries, 2002 (percent)

Importing income group/country	OTRI for all countries	OTRI for low-income countries	OTRI for least developed countries	OTRI for Sub-Saharan Africa	Share of low-income country exports	Share of low-income countries in total imports from developing countries
High-income OECD	12	14	12	11	68	11
Canada	6	7	6	5	1	8
European Union	13	15	13	14	27	11
Japan	14	24	21	18	10	13
United States	8	6	5	4	23	10

Source: Kee, Nicita, and Olarreaga 2005a.

Note: OTRI stands for overall trade restrictiveness index.

TABLE 4.8 Globally, trade restrictiveness is highest for agriculture, 2002 (overall trade restrictiveness index, percent)

Exporting region/ income group	Importing region/income group						
	High-income OECD	Quad	Middle-income	Low-income	Least developed	Sub-Saharan Africa	World
Total trade							
High-income OECD	9	8	19	23	21	23	14
Quad	8	8	19	23	21	23	14
Middle-income	9	9	22	25	22	25	15
Low-income	14	14	25	26	22	26	20
Least developed	12	12	24	25	22	26	18
Sub-Saharan Africa	11	11	23	24	21	24	17
World	12	12	20	22	21	23	18
Agriculture							
High-income OECD	36	35	45	36	28	34	39
Quad	31	30	46	37	29	34	37
Middle-income	49	49	42	36	28	33	43
Low-income	43	43	40	34	27	31	39
Least developed	38	38	39	32	26	30	37
Sub-Saharan Africa	34	35	38	33	26	30	35
World	44	43	36	30	26	32	35
Manufacturing							
High-income OECD	5	5	15	21	19	21	10
Quad	6	6	15	21	20	21	11
Middle-income	4	4	19	23	21	24	11
Low-income	4	4	20	22	21	24	13
Least developed	3	3	20	22	21	24	12
Sub-Saharan Africa	2	2	16	19	18	21	9
World	6	6	17	20	20	22	12

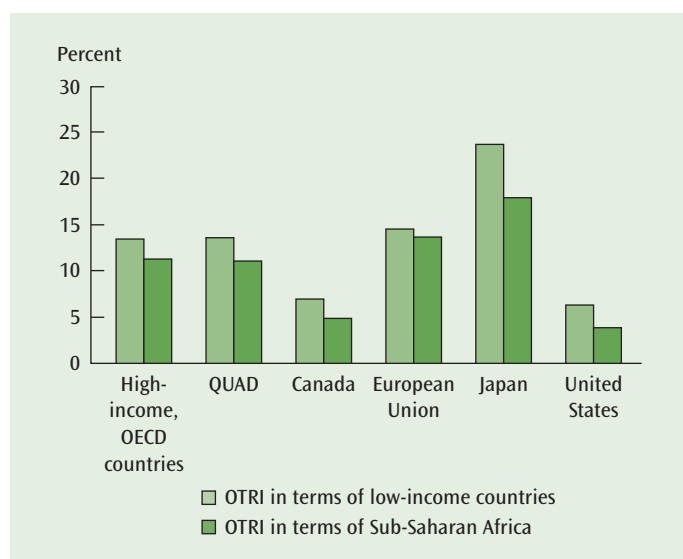
Source: Kee, Nicita, and Olarreaga, 2005a.

Note: The Quad are Canada, the European Union, Japan, and the United States.

Act, OTRIs for low-income countries average 14 percent (figure 4.6).

A reason for this is that the incidence of nontariff measures in a number of OECD countries tends to be disproportionately high on products that developing countries export—especially agricultural products. Thus the higher OTRIs against low-income countries primarily reflect the product composition of imports—developing countries happen to export the goods most affected by nontariff measures—and the fact that not all low-income countries benefit equally from the preferential access regimes offered by the OECD members concerned.¹⁸ An implication is that nontariff measures matter, in that they tend to reduce the effective value of the preferential access granted through tariff exemptions. Insofar as the incidence of nontariff measures is higher in developing countries, there is a case for additional assistance to be directed at these countries to help them address the underlying regulatory requirements. The need for this increases the more ambitious the outcome of the Doha Round will be, as deep multilateral liberalization will reduce the value of existing tariff preferences.

FIGURE 4.6 OECD trade restrictiveness remains high for developing countries



Source: Kee, Nicita, and Olarreaga 2005c.

Note: Quad countries are Canada, the EU, Japan, and the United States.

Another striking feature of the OECD OTRI estimates is that agricultural subsidies play only a small role in determining the magnitude of OTRIs for most countries that employ them (see figure 4.5). That is because, from a market access perspective, subsidies are often redundant—because border barriers such as tariffs and tariff rate quotas are the instruments that determine the (world) price impacts. If border barriers were to be reduced significantly, agricultural subsidies would become much more important determinants of trade restrictiveness; thus they are not innocuous. But the implication is that policies (and negotiations) should focus on removing border protection. Lowering agricultural subsidies without lowering border protection will not have much effect.¹⁹

Although market access dominates in terms of affecting world prices and distorting domestic markets, subsidies are very important for some developing countries.²⁰ Cotton is an example where global trade barriers are low, but subsidies in several OECD countries are large—with well-documented detrimental effects on West African and other developing country producers. Cotton accounts for about 30 percent of exports from the four West African nations that proposed a cotton initiative in the WTO, and for a significant share of income for millions of poor farming households in the region.²¹ Recent U.S. cotton subsidies have ranged from \$1.5 billion to almost \$4.0 billion a year, depending on market conditions.²² Eliminating U.S. cotton programs, while leaving in place other farm programs, would reduce U.S. production by 25–30 percent, reduce U.S. exports by about 40 percent, and raise world prices by about 10 percent. The annual losses for LDC cotton producers resulting from U.S. and EU support policies are in the range of \$120–240 million.²³

The Incidence of Developing Country Trade Policies

Developing countries have higher average OTRIs than do high-income OECD countries. Among regions, the Middle East and North

Africa have the highest OTRIs, followed by Sub-Saharan Africa, South Asia, and East Asia (table 4.9). Eastern European and Central Asian countries, many of which acceded to the European Union in 2004, have the lowest OTRIs. The average OTRI for all developing countries is 20 percent. As with high-income OECD countries, manufacturing protection tends to be lower than restrictions applied to agricultural trade, though the differences are smaller than in the OECD countries (see table 4.8). On average the world has an OTRI in agriculture that is three times that in manufacturing—35 percent compared with 12 percent—with high- and middle-income countries being more restrictive than low-income countries. The LDCs have the lowest agricultural OTRIs of all income-based country groups. Conversely, developing countries have much higher manufacturing OTRIs, with the highest average levels observed in Sub-Saharan Africa. This generally reflects either a desire to protect local industries or to achieve fiscal objectives; tariffs account for a substantial share of government revenues in many Sub-Saharan countries.

In terms of the incidence of OTRIs, a pattern similar to that for OECD countries is observed for developing countries—OTRIs

are higher for exports from other developing countries (though the LDCs confront slightly lower average OTRIs than do other low-income countries; see table 4.8). Thus, in addition to facing high barriers in OECD countries, developing countries impose high barriers on trade with one another, and the incidence of these intra-developing country trade restrictions is higher for poorer countries—just as the incidence of OECD trade restrictions is higher for poorer countries.

These estimates show that the protectionist trade policies of high-income OECD countries are not the only external problem undermining the ability of developing countries to use trade for development and poverty reduction. Indeed, middle-income countries maintain much higher levels of protection. Reducing such protection would be in their own interest and that of poorer countries—which often confront higher barriers in global markets than do rich countries, implying that the structure of trade policies in middle-income countries is antipoor. Thus reform of trade policies in developing countries should be a central part of the trade reform agenda. This conclusion also emerges from the research summarized below assessing the potential gains from the Doha Round—

TABLE 4.9 Developing countries impose high restrictions on trade with one another, 2002 (overall trade restrictiveness index, percent)

Importing region/income group	OTRI for all countries	OTRI for low-income countries	OTRI for least developed countries	OTRI for Sub-Saharan Africa
East Asia and Pacific	21	26	26	26
Europe and Central Asia	12	16	15	16
Latin America and the Caribbean	18	21	20	20
Middle East and North Africa	31	48	47	40
South Asia	23	29	27	28
Sub-Saharan Africa	23	26	26	24
Developing countries	20	25	25	23
Least developed countries	21	22	22	21
Low-income countries	22	26	25	24
Middle-income countries	20	25	24	23

Source: Kee, Nicita and Olarreaga, 2005a.

which are potentially large only if the round encompasses significant further liberalization of trade by developing countries.

The Doha Round Challenge

The WTO is the primary multilateral instrument through which countries can reduce the trade protection summarized above. In August 2004 the WTO General Council reached several agreements to guide future negotiations under the Doha Round. The agreements were a welcome step forward after the setback at Cancun, but they leave key questions unanswered and extend the timeframe of the round. The agreements include a framework for negotiations on agriculture and industrial products, recommendations on services, and modalities for negotiating improved customs procedures (trade facilitation; table 4.10).

Why Ambition Matters: Likely Impacts of Different Doha Round Outcomes

The extent to which reform commitments under the Doha Round will have economic repercussions depends on whether they affect

applied policies. WTO negotiators focus not on applied tariffs and subsidies but on the levels of import tariffs, export subsidies, and domestic support for agriculture that countries commit not to exceed. These so-called bindings are often much higher than applied levels of protection, especially in developing countries. Thus, if cuts to bound tariffs or subsidy rates are not very large, or the gap between bound and applied rates is large, the reforms required by a Doha deal may be minimal. So, much depends on the extent to which changes in bindings translate into real reductions in applied protection levels. Much also depends on the magnitude of exceptions and exemptions for specific instruments or products.

Deep trade reform could generate large global gains. Freeing all merchandise trade and abolishing all trade-distorting agriculture subsidies would boost global welfare by \$80–280 billion a year by 2015, depending on whether exogenous population and labor supply growth, savings-driven capital accumulation, and labor-augmenting technological progress are taken into account.²⁴ These estimates ignore possible dynamic productivity gains, exploitation of economies of scale,

TABLE 4.10 Key elements of the August 2004 WTO framework agreement

Agriculture subsidies	All forms of agricultural export subsidies to be eliminated. Overall bound level of trade-distorting domestic support to be reduced over time, with a 20 percent reduction in the first year. Members with higher levels of support to commit to larger reductions, with product-specific caps on the most trade-distorting forms of agricultural support.
Market access in agriculture	Nonlinear formula to ensure deeper cuts in higher tariffs. A category of “sensitive” products to be subject to greater flexibility. Possibility of trading off more modest tariff reductions against larger tariff rate quotas.
Cotton	To be dealt with “ambitiously and expeditiously” within the agriculture negotiations, by a special subcommittee.
Non-agriculture market access	No a priori exclusions. Recognition that credit should be given for autonomous liberalization. Nonlinear formula to tackle tariff peaks, high tariffs, and tariff escalation, to be applied on a line-by-line basis.
Services	Revised offers to be tabled by May 2005, and developing countries to be given technical assistance to help them participate in the negotiations.
Trade facilitation	Negotiations to be part of the Doha Round, with a focus on expediting the movement, release, and clearance of goods, with implementation by developing countries linked to provision of technical assistance.

effects of increased competition on markups and X-inefficiency in production, and liberalization of trade in services—including through greater temporary international mobility of service suppliers. They also assume that beneficiary countries make full use of preferences and that any resulting rents accrue to exporters. Taking such factors into account greatly increases the potential aggregate gains and affects the distribution of net effects across countries.²⁵

Recent research suggests that developing countries would obtain about one-third of the global gain from freeing all merchandise trade, well above their one-fifth share of global GDP. Recent analyses using global general equilibrium models and the latest databases on trade protection and preferences suggest that developing countries would receive a 1.2 percent static gain over initial welfare (real income) levels, compared with just 0.6 percent for developed countries (assuming an overall global gain of \$280 billion). The larger gain for developing countries

is partly because of their relatively high tariffs—meaning, they would reap substantial efficiency gains from reforming their protection—and partly because their exporters face much higher farm and textile tariffs in developed countries than do exporters from other developed countries, notwithstanding non-reciprocal tariff preferences for many developing countries.²⁶

Agriculture is the most important sector in realizing these potential gains, reflecting the extensive assistance it receives relative to other sectors. Food and agriculture policies are responsible for more than three-fifths of the global gain forgone by merchandise trade distortions (table 4.11)—despite the fact that agriculture and food processing account for less than 10 percent of world trade and less than 4 percent of global GDP. Agriculture is as important for the welfare of developing countries as it is for the world as a whole: their gains from global agricultural liberalization account for almost two-thirds of their total potential gains, compared with one-

TABLE 4.11 Most economic welfare benefits of full merchandise trade liberalization would come from agriculture, 2015 (percent)

Global welfare benefits				
Source of benefits	Sector liberalized			
	Agriculture and food	Textiles and clothing	Other manufactures	All goods
Developed countries' policies	46	6	3	55
Developing countries' policies	15	9	21	45
Total	61	15	24	100
Developing countries' welfare benefits				
Source of benefits	Sector liberalized			
	Agriculture and food	Textiles and clothing	Other manufactures	All goods
Developed countries' policies	28	16	6	50
Developing countries' policies	35	9	6	50
Total	63	25	12	100

Source: Anderson, Martin, and van der Mensbrugghe 2005, table 12.4.

Notes: (1) These data are shares based on a simulated global gain of \$280 billion that takes into account exogenous population and labor supply growth, savings-driven capital accumulation, and labor-augmenting technological progress between 2001 (base year) and 2015. Developed countries include the transition economies of Eastern Europe and the former Soviet Union. (2) The share of global welfare gains due to liberalization by middle-income countries is 12 percent for agriculture and food liberalization; 7 percent for textiles and clothing; and 13 percent for other manufactures.

quarter for textiles and clothing and one-eighth for other merchandise liberalization (see table 4.11).

Stronger subsidy disciplines are important, but increased market access in agriculture is crucial. High applied tariffs on agricultural relative to nonfarm products are the main reason food and agriculture policies account for 61 percent of the welfare cost of merchandise trade distortions. Aggregating across all products, subsidies for farm production and exports are only minor contributors: 4 and 1 percentage points, respectively, compared with 56 points due to agricultural tariffs.²⁷ Tariffs are more important in developing than in developed countries, because subsidies are much less prevalent. Given that bound tariff rates are high in agriculture, large cuts are needed to make a difference. The average bound tariff rate in developed countries is almost twice the average applied rate; in developing countries the difference is even greater. To lower the average global agricultural tariff by one-third, bound rates would have to be reduced for developed countries by at least 45 percent and the highest tariffs by up to 75 percent.²⁸

Even large cuts in bound tariffs will do little if exemptions for “sensitive” products are allowed. If WTO members limit tariff cuts for “sensitive” farm products such as rice, sugar, milk, beef, fruits, and vegetables, the prospective gains from Doha could be greatly diminished. Classifying 2 percent of six-digit Harmonized System agricultural tariff lines in developed countries as sensitive (and 4 percent in developing countries, to reflect demands for differential treatment) and subjecting them to just a 15 percent tariff cut would shrink by three-quarters the welfare gains from global agricultural reform.²⁹ These findings illustrate the importance of the call made in *Global Monitoring Report 2004* for ambitious targets with respect to lowering agricultural tariffs, for example, to no more than 10 percent.

While agricultural market access liberalization is by far the most critical merchandise trade issue on the negotiating table from

a developing country perspective, disciplining domestic production subsidies and phasing out export subsidies is also important. In part these steps are needed to prevent “re-instrumentation” of assistance from tariffs to domestic subsidies. Moreover, some OECD subsidies are very important for developing countries. Removing cotton subsidies would raise the price of cotton in international markets and benefit developing country exporters. For Sub-Saharan Africa, recent research suggests that the increase in export prices relative to manufactures overall would be small. But cotton exports from Sub-Saharan Africa would increase 75 percent. The share of all developing countries in global cotton exports would expand to 85 percent, instead of the 56 percent projected for 2015.³⁰

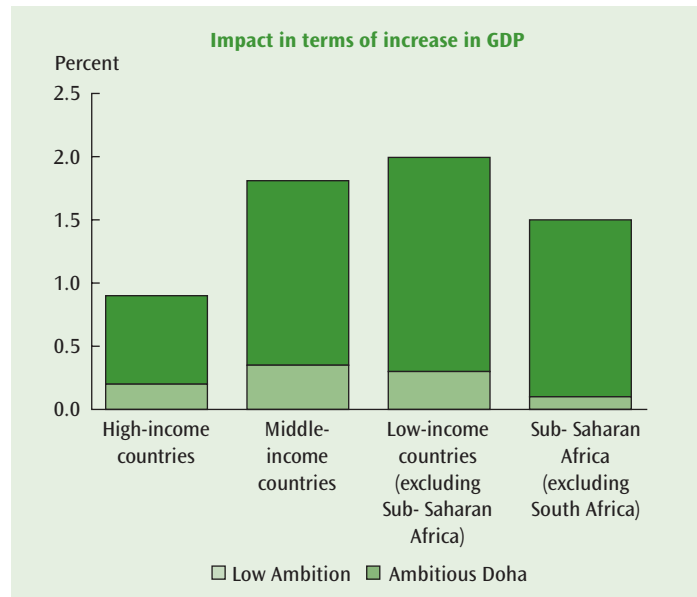
The foregoing analyses of possible outcomes of negotiations consider policy instruments such as tariffs, preferences, subsidies, and tariff rate quotas in agriculture. But they do not consider the effects of nontariff measures and mostly ignore the implications of removing barriers to trade and investment in services. Given that nontariff measures play an important role in determining the overall trade restrictiveness of countries, reducing the incidence of such policies could generate additional gains for developing countries and the world as a whole. Using a partial equilibrium framework that allows much greater disaggregation across products and countries than is possible in global computable general equilibrium models, a recent study compared the likely effects of an unambitious Doha Round and an ambitious one that addresses nontariff measures.³¹ The low-ambition round is defined as causing a 40 percent cut in bound tariffs, a reduction in tariff peaks to a maximum of 50 percent, a 40 percent reduction in domestic agriculture subsidies, elimination of export subsidies, and an improvement in trade facilitation that increases world trade by an average of 2 percent.³² Conversely, an ambitious Doha Round would result in free trade (elimination of all applied tariffs), a 50 percent cut in the

restrictiveness of nontariff measures, elimination of trade-distorting agriculture production and export subsidies, and the same improvement in trade facilitation.

An unambitious Doha Round would not do much to improve developing country welfare or help achieve the MDGs. Static global welfare gains would be about \$59 billion. In contrast, an ambitious Doha agenda could nearly quintuple these gains, to \$269 billion. Full tariff and subsidy reform without any changes in nontariff measures would generate “only” \$111 billion.³³ Sub-Saharan Africa would see its welfare increase by an estimated \$2.8 billion under the ambitious scenario, compared with only \$140 million under the type of agreement that current trends suggest is likely to emerge. The low-ambition scenario would raise Sub-Saharan GDP by 0.1 percent. In contrast, an ambitious Doha Round outcome could boost GDP by 1.3 percent. Around 40 percent of the gains from the round would accrue to developing countries under both scenarios, with the greatest absolute amount going to middle-income nations. Low-income countries would obtain 14 percent of the developing world welfare gains. Under both scenarios welfare gains relative to GDP are largest for low- and middle-income countries (figure 4.7).

This analysis suggests that efforts to reduce the incidence of nontariff measures are important. But as noted, not all these measures are discriminatory. In the case of regulatory product requirements—which account for a large share of nontariff measures in many high-income countries—attenuating the effects of enforcement is unlikely to be costless. Thus the additional \$150 billion that could be attained by halving the ad valorem equivalent of nontariff measures is an upper bound estimate of potential net gains. Determining how to attenuate the impacts of nontariff measures at the lowest cost requires both country-specific analysis and a concerted effort to improve the global information base on applied nontariff policies. But it is probable that much of the appropriate response

FIGURE 4.7 A low-ambition round vs. deep WTO reforms



Source: Hoekman, Nicita, and Olarreaga (2005).

revolves around “aid for trade” to improve quality, testing, conformity assessment capacity, and so on.

Prospects for realizing the potential of trade to support development are also conditional on further liberalization by developing countries. As revealed by the OTRIs, developing countries maintain much higher trade barriers against nonagricultural products than do OECD countries and impose high trade barriers on each other. Combined with the fact that many (especially middle-income) developing countries have been growing more rapidly, prospects for greater trade flows are greatest between developing countries. Moreover, most of the benefits of trade reform derive from what countries do themselves—as discussed in *Global Monitoring Report 2004* and numerous recent reports, including the United Nations MDG taskforce report on trade, maintaining high barriers to trade imposes costs on an economy.

If developing countries as a group were not to participate in liberalizing trade under the Doha Round, not only would global gains fall significantly—by close to one-half—but potential gains to developing countries would

fall by 50 percent.³⁴ Sub-Saharan Africa and the LDCs could even end up losing from the Doha Round if they do not pursue reforms. The reason is that the efficiency gains from own liberalization are needed to help offset terms of trade losses that may arise because food prices rise (in the case of net food importers), tariff preferences are eroded, or market share is lost to other developing countries that pursue reforms (or have already done so).

Services

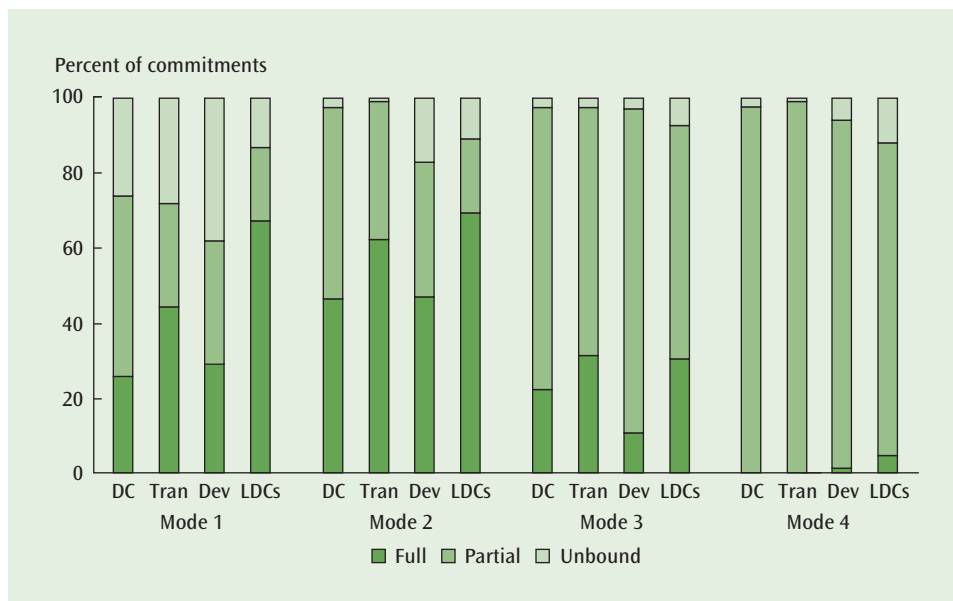
The foregoing discussion largely ignores domestic reform and liberalization of service sector policies, an area where research suggests there is great potential for gains, in terms of both efficiency and equity. Countries such as Brazil and India have seen exports of business process services such as call centers, software development, and back-office services expand rapidly. African exports of commercial services grew by more than 20 percent in 2003, in line

with merchandise export growth, and account for 18 percent of total exports—the largest share of all developing regions.³⁵

Developing countries have called for specific commitments on improving access to OECD markets for service suppliers, especially through temporary migration (mode 4 in the General Agreement on Trade in Services, or GATS). This is the main area where virtually no commitments have been made (figure 4.8). As noted in *Global Monitoring Report 2004*, it is also the area with the greatest potential for increased exports from developing countries (figure 4.9).

To date, little progress has been made on services negotiations. Although numerous requests have been put on the table, only 47 first-round offers have been put forward by WTO members.³⁶ Most of these are of limited value as they do not go beyond status quo policies. The LDCs have made the fewest commitments on services in the WTO—in contrast to recently acceded countries, which have been asked to make far more commit-

FIGURE 4.8 WTO Market access commitments for services by mode of supply



Source: Marchetti (2004), updating WTO document S/C/W/99.

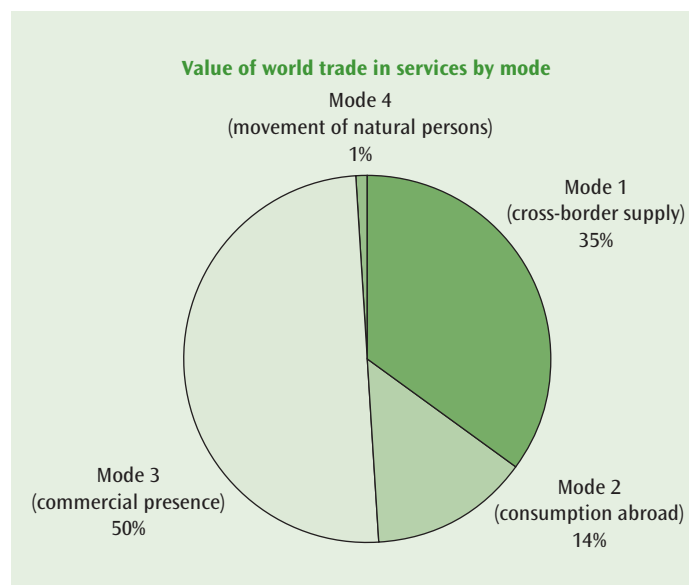
Note: The above information is as of August 2004 and is based on a sample of 37 representative sectors. DC (developed countries); Tran (transition economies); Dev (developing countries). Full implies a binding commitment to market access and national treatment; unbound implies no commitments were made; and partial implies specific policies limiting access or involving discrimination were bound.

ments than most existing members (table 4.12). There is great scope for more advanced countries to lock in liberal trade and investment policies in areas that matter to developing countries—especially on cross-border trade (mode 1)—and to increase the extent to which service markets can be contested through temporary migration of service providers. Conversely, developing countries can do much more to use the WTO as an instrument to commit to greater liberalization of their services. While considerations of “balance” create incentives not to do so until greater clarity has emerged on what is likely to be feasible in other areas (such as agriculture), services are an area where a *quid pro quo* can be offered that is likely to benefit the committing country. Much of the agenda here revolves around making commitments targeted at attracting greater foreign direct investment (FDI) in services (mode 3 of the GATS). Encouraging such investment in both goods and services production is a direct way to improve the investment climate.

FDI can do much to enhance an economy’s productivity, because foreign service suppliers offer new technologies, new products, and more differentiated and higher-quality services. The increased competition associated with open access to service markets also puts pressure on the prices and performance of incumbent firms, reducing input costs for firms that buy the services. Moreover, the importance of an efficient services sector goes beyond the sector’s contribution to a country’s balance of payments; such efficiency is also a key determinant of domestic firms’ competitiveness. Key services that influence firms’ ability to participate in world trade include telecommunications, transportation, financial, and other business services such as accounting and legal services.

In many of the LDCs, inefficient business services are an important barrier to effective integration with world markets. High-cost trade support services act as a tax on exporters and ultimately on growth and poverty reduction. For a small economy confronting given world prices of traded goods,

FIGURE 4.9 Foreign direct investment and cross-border exchange account for most trade in services



Source: Maurer (2004)

TABLE 4.12 Developing countries have made fewer market access and national treatment commitments for services under the WTO

Country group	Average number of subsectors committed per country	Range (lowest/highest number of committed subsectors)
Developing countries	54	1–154
Least developed countries	20	1–110
Transition economies ^a	106	58–154
Developed countries	108	87–117
Countries acceded since 1995	106	37–154

Source: Marchetti 2004.

Note: Data as of August 2004. The total number of subsectors in which commitments can be made is 160. These commitments may be full or partial bindings; see note to figure 4.8.

a. Includes only European and Central Asian transition economies.

higher service costs reduce export prices and increase import prices. As a result exporting industries must pay lower wages or accept lower returns on capital. For example, freight rates for goods originating in Sub-Saharan African countries are often considerably higher than for similar goods originating in other countries, and thus have contributed to the region’s weak trade performance and high

poverty in recent decades. High transportation costs are partly due to shortcomings in infrastructure, geography, and the economic size of markets, but they may also reflect policies that restrict competition—such as cargo reservation schemes or entry barriers into air and maritime transport.

The Doha Round, Low-Income Countries, and Sub-Saharan Africa

Market access is a necessary but insufficient condition for harnessing trade for development. As noted in *Global Monitoring Report 2004*, domestic supply constraints are the main reason for the lack of trade growth and diversification in many developing countries. Without action to improve supply capacity and reduce transactions costs, trade opportunities cannot be fully exploited and the potential gains discussed previously will not be realized. The agenda spans many areas, many of them “behind-the-border.” Dealing with these issues will require action in developing countries and assistance from developed countries, including both finance and efforts to reduce the costs of nontariff measures.

Recent country studies that analyze the potential impacts of global reforms on African poverty, using information from household surveys, show that trade policy actions by themselves will have limited effects—positive or negative. Complementary reforms and investments are needed to stimulate the desired supply response to changed incentives. In Ethiopia, one of the world’s poorest countries (with more than two-thirds of the population living on less than \$2 a day), the Doha Round alone will not have much significant effect on poverty.³⁷ That is because any impact on the prices and quantities of Ethiopia’s main exports—coffee, qat (a mild stimulant exported mostly to neighboring countries), and livestock—will not be large. Moreover, exports represent a small part of GDP: annual exports are about \$600 million, or \$10 per capita, equal to 15 percent of GDP—one of the lowest shares in Sub-Saharan Africa. Thus even a hypothetical doubling of international demand for Ethiopian products

would have limited impact on poverty. Domestic markets are poorly connected, limiting the price and quantity effects of any trade policy changes in rural areas, where most poor people live. If price signals fail to reach households, supply responses to international shocks will be low. In addition, low agricultural productivity implies that supply responses will be associated with higher production costs, reducing net benefits. Finally, Ethiopian households, especially the poorest, are insulated from market shocks (and thus effects of trade policies) because they are widely engaged in subsistence activity. More than half the average budget of poor households is from subsistence.

This does not mean that an ambitious Doha Round would not bring opportunities to Ethiopia. It would increase international demand for Ethiopian products. But for that to translate into quantifiable benefits, the increased demand would have to be accompanied by improved productivity (rather than a simple increase in production), to also spur nonexported agricultural production (especially staple crops). And given that most poor Ethiopians live in remote areas, increased productivity alone may not have a large effect on poverty in the absence of complementary policies. Better infrastructure and access to credit are two preconditions for integrating the rural poor with domestic markets and reducing subsistence.

A similar conclusion arises from a recent study on Zambia.³⁸ In 1998 more than 70 percent of the country’s population lived in poverty. Using an approach similar to the analysis of Ethiopia, in terms of projecting the likely effects of a Doha Round on world prices, the authors investigate the impact of trade reforms on household welfare through effects on consumption and income. They conclude that only small impacts can be expected from a Doha Round set of trade reforms. This reflects the fact that the round will likely generate only a small change in prices, so gains and losses for producers and consumers will be small as well. Moreover, for Zambian households large shares of spending and income are related to home-produced goods—which are

unlikely to be affected by trade liberalization. Larger effects are predicted on the income side, particularly in terms of higher wages, employment opportunities, and a move from subsistence to market-oriented agricultural activities. Again, a key finding is that trade policy by itself is not enough. Complementary policies are important in allowing households to take full advantage of trade liberalization and global market opportunities. This result is illustrated by two recent case studies: one on the role of extension services in boosting productivity among poor Zambian farmers, and another on the role of job programs in providing employment for heads of households.³⁹

An analysis for Madagascar similarly concludes that global trade reforms by themselves may have limited impact.⁴⁰ Many of the country's exports do not confront high protection (vanilla, cloves, crustaceans, semiprecious

stones), most poor people live in rural areas not connected to markets (preventing the pass-through effects of border price changes on supply), and productivity is low. Moreover, limited competition in domestic markets is likely to concentrate gains from trade in the hands of traders and exporters, as opposed to poor farmers.⁴¹ Global liberalization would increase international demand for Madagascar's exports, but to take full advantage of this it would be necessary to raise productivity and reduce the transportation costs of getting products to urban areas and export hubs. Past unilateral reforms and improved access to export markets show that trade can reduce poverty—although given their low initial base, the impact of greater exports can be limited only in the short to medium term (box 4.2).⁴²

In sum, country-based analysis of the poverty impacts of global trade reforms in

BOX 4.2 Why has rapid export growth failed to significantly reduce poverty in Madagascar?

Fueled by low labor costs, relocation of textile and apparel firms from neighboring Mauritius, preferences granted by the U.S. African Growth and Opportunity Act, and the creation of export processing zones, Madagascar's textiles sector experienced dramatic growth in the late 1990s. Textile and apparel exports increased from \$100 million in 1995 to almost \$500 million in 2001. In the same period employment in the sector grew from 30,000 to 200,000 individuals. Expansion of the textiles and apparel industry has enabled many individuals and households to increase income and in some cases escape poverty. But the welfare effects of this expansion have been geographically confined: most of the employment has been created in a few urban areas with relatively low poverty.

Most of the gains, in both absolute and relative terms, have accrued to nonpoor households. As a result this export-led growth has increased inequality between poor and nonpoor people, between urban and rural areas, and between skilled and unskilled workers. Skilled workers have experienced rapidly increasing wages, while rural areas have largely been cut off from the effects of the growing textiles and apparel sector. Unskilled workers have benefited only marginally, because a large pool of unemployed and underemployed workers has kept their wages from rising. But poor households located in the capital, where most of the employment was created, have benefited. It is estimated that five years of expansion of the textiles sector reduced poverty by almost 1 percentage point, or about 150,000 individuals.

These results suggest that two factors are required if export-led economic growth is to reduce poverty significantly. First, growth and job creation must not be restricted to a few geographic areas. Dispersion could be achieved by creating geographically diverse export processing zones to generate job opportunities for a wider range of the population. Second, to facilitate their absorption into the formal labor force, poor people must be assisted in obtaining the skills sought by expanding industries. This can be achieved by providing government-sponsored training or incentives for firms to provide training.

Source: Nicita 2005.

very poor countries suggests that the first-order (or static) effects are small. Price effects, whatever the magnitude, will be passed through incompletely, little will be done to attenuate the effects of nontariff measures, and many LDCs have concentrated export bundles involving products that often are not heavily protected in world markets (such as vanilla in Madagascar and coffee in Ethiopia). Second-order effects—allowing for adjustments on the supply side through movements from subsistence into market participation, changes in crops, and moves out of unemployment—can be larger. But for any positive effects to be significant, global trade reforms must be accompanied by complementary actions targeted at increasing the supply response. Such actions could center on reducing transportation costs from remote areas, increasing farm productivity through extension services, and so on.

This conclusion is supported by the many Diagnostic Trade Integration Studies conducted under Integrated Framework auspices for the LDCs, as well as similar assessments for other developing countries. These find that trade cannot play much of a positive role if the macroeconomic climate is unstable and the business environment is hostile, and that for many countries the key challenges are to reduce constraints on competitiveness and supply responses—especially lack of transport, energy, and water infrastructure, lack of access to finance, and weak worker skills. Improving trade policies and taking action to facilitate trade by strengthening and streamlining customs can have a significant payoff, but a major impact on poverty requires reducing domestic supply constraints.

Thus trade may make only a limited contribution to reducing poverty in the short to medium run. And though its potential is substantial, especially in the long run, trade is just part of the solution.⁴³ Even in Kenya and Lesotho, African countries with dynamic export sectors (cut flowers and apparel, respectively), booming exports have not had major benefits for employment, and development of supply industries (backward linkages) has been slow.⁴⁴

Trade and Development— Toward a Concerted Response

The traditional international policy response to the challenge of expanding trade in developing countries has been a mix of preferential access and development assistance. In recent years preferential access has been deepened and made more meaningful through the EU Everything But Arms initiative and the U.S. African Growth and Opportunity Act. Efforts have also been strengthened to provide more aid for trade.

All these programs have been beneficial. But preferences are an eroding asset: they have become less valuable as importing countries have liberalized their trade—both on a nondiscriminatory MFN basis and as a result of regional trade agreements. The value of preferences will be further eroded the more the Doha Round results in significant further liberalization. The answer is not to stop global liberalization to maintain the value of preferences. Instead, action is required on complementary instruments to help countries address competitiveness challenges and exploit market access opportunities. This includes measures to reduce the incidence of nontariff measures.

Market Access: Beyond Tariff Preferences

To some extent tariff preferences offset the explicit discrimination against developing country trade reflected in higher tariffs on key exports and the higher incidence of nontariff measures revealed by the OTRIs discussed previously. Given that developing countries generally do not give significant tariff preferences to other poor countries, preferences only significantly affect the incidence of trade policies in developed countries. A seemingly logical implication of this is that advanced developing countries should also offer preferential access to their markets to the poorest countries. At the 2004 meeting of the United Nations Conference on Trade and Development in Brazil, it was agreed that countries would seek to do so in the framework of the Global System of Trade Preferences.⁴⁵

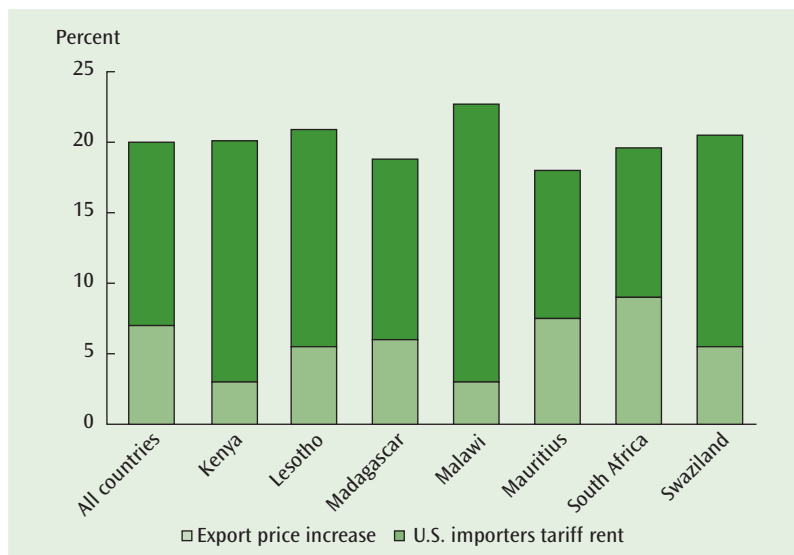
Much of the literature on this subject concludes that preferences have not resulted in the desired export expansion and diversification in many countries. There have been several notable exceptions, but these are associated with quantitative restrictions being imposed on competitive suppliers. Reasons why benefits have often proven limited include restrictive rules of origin—reducing utilization of preferences below 100 percent, especially for key manufactures such as clothing,⁴⁶ and excluding “sensitive” products from the coverage of arrangements. Recent preference schemes for the poorest countries—such as the EU Everything But Arms

initiative for the LDCs, the U.S. African Growth and Opportunity Act for eligible Sub-Saharan countries, and Canada’s duty- and quota-free access program for the LDCs—provide more comprehensive coverage than do traditional General System of Preferences-type programs. In the case of the African Growth and Opportunity Act, they also apply more liberal rules of origin and have allowed exports of textiles to expand rapidly from eligible countries.

While preferential access may generate rents and stimulate export-oriented production in countries that are granted liberal origin rules, any rents are shared with importers (box 4.3).⁴⁷

BOX 4.3 Many of the rents created by trade preferences accrue to importers

For exporters, benefits from trade preferences depend on the size of the rents associated with being able to sell into protected markets and on their capacity to capture those rents. Recent research has found that importers may be able to capture some, if not most, of such rents. For example, one study found that the average export price increase for products benefiting from preferences under the African Growth and Opportunity Act was about 6 percent, whereas the average MFN tariff for these products was some 20 percent (see figure). Thus, on average exporters received around one-third of the tariff rent. Moreover, poorer and smaller countries tended to obtain smaller shares. The estimates ranged from 14 percent in Malawi to 46 percent in South Africa. Reasons why importers and retailers capture a large share of the rents include the monopsony power of buyers and limited bargaining power of African exporters—perhaps reflecting limited or asymmetric information.



Source: Olarreaga and Özden 2004.

More important, such rents are highest where there are also quantitative restrictions on competitive suppliers (as under the now-expired Agreement on Textiles and Clothing and the EU sugar regime). These regimes are being (or have been) dismantled, implying erosion of rents even before the conclusion of the Doha Round. One response is to deepen and extend preferences to additional countries. The experience under AGOA or EBA suggests that existing tariff preference programs could be made more effective by adopting common, liberal rules of origin. Several OECD countries have also proposed that middle-income countries apply access schemes like those under the act.

While a decision to adopt common, liberal rules of origin would be desirable if put in place rapidly, and preferential access to large middle-income markets would be of value, it must be recognized that such “affirmative action” is not a panacea for poor countries to expand and diversify their trade. One reason is the earlier observation that preferences that have generated rents have largely been accompanied by quotas. With the implementation of the Agreement on Textiles and Clothing, these have largely been removed. A second reason is that many countries have not been able to benefit from existing deep preferences, so extending these may not have much effect. Third, there is a global negative externality associated with preference programs—they create incentives not to pursue global liberalization, especially in sectors where distortions are highest. Preferences for some countries by definition imply greater discrimination against other, less preferred developing countries, and thus trade diversion—because the set of goods that beneficiary developing countries produce overlaps with those of other developing countries that are not beneficiaries. This trade diversion and discrimination has created significant tension between developing countries and has recently given rise to several formal WTO disputes. Finally, in terms of numbers, most of the world’s poor people

do not live in the poorest countries, and preferences for some come at the cost of equally poor households in other, less preferred developing countries.

Given the systemic downsides, limited benefits, and historical inability of many poor countries in Africa and elsewhere to use preferences, a decision to shift away from preferential “trade as aid” toward more efficient, effective instruments to support poor countries could both improve development outcomes and help strengthen the multilateral trading system. More effective integration of the poorest countries with the trading system requires instruments aimed at improving the productivity and competitiveness of firms and farmers in these countries. Supply constraints are the primary factors that have constrained the ability of many African countries to benefit from preferences.⁴⁸ This suggests that the main need is to improve trade capacity and facilitate diversification. In part this can be pursued through a shift to more (and more effective) development assistance that targets domestic supply constraints as well as measures to reduce the costs of entering foreign markets. Such aid for trade is particularly urgent for countries that confront preference erosion as a result of multilateral reforms. This is a significant economic issue for small countries dependent on sugar, bananas, and to a lesser extent clothing exports—products where protection and thus preference margins are high. Importantly, most of these are not the poorest countries, but middle-income economies.⁴⁹

Aid for Trade

Bolstering trade capacity by linking farmers to markets and improving their productivity, lowering transaction costs by identifying and removing red tape and improving customs clearance, or putting in place the regulatory preconditions for benefiting from and managing liberalization—especially in the area of services—are all institution-intensive. The needs are not just for trade infrastructure and

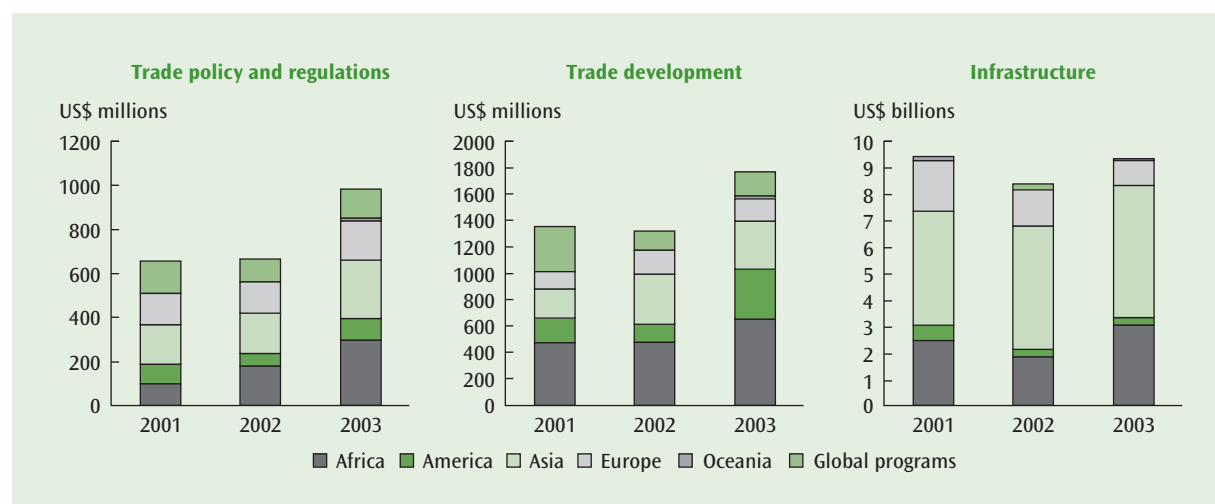
trade facilitation, but also involve complementary actions to implement safety nets, enhance access to credit, improve health and education services, and pursue effective regulation to attain efficiency and equity objectives. This agenda extends well beyond trade integration. It is largely “additive” in that actions on these fronts can be pursued in parallel.⁵⁰ On all these fronts development assistance can play an important role in enhancing the overall gains from trade and managing costs and downside risks. A specific area where assistance may have high payoffs is in reducing the costs of satisfying nontariff regulatory policies in export markets.

In recent years progress has been made in expanding trade-related technical assistance and capacity building. The WTO and OECD database that tracks such assistance distinguishes between trade policy and regulations (technical assistance for product standards, integration of trade with development plans, trade facilitation), trade development (trade promotion, market development activities, and so on), and infrastructure. Infrastructure is the largest of these categories but is not limited to trade-related projects. The share of

total aid commitments that went to support trade policy and regulations and trade development rose from 3.6 percent in 2002 to 4.2 percent in 2003.⁵¹ About one-third of this support went to the LDCs. Aid has been expanding most rapidly for trade policy and regulations (figure 4.10), reaching almost \$1 billion in 2003, with the amount allocated to Africa tripling between 2001 and 2003. Commitments for trade development activities, which amounted to some \$1.35 billion a year in 2001 and 2002, reached \$1.8 billion in 2003.⁵² Infrastructure assistance was stable at around \$8 to \$9 billion a year between 2001 and 2003, with Asia by far the largest recipient region. In 2002 Africa's share of infrastructure aid diminished, reflecting an emphasis on social sectors.

The World Bank has continued to expand its activities and support for trade, focusing on trade integration broadly defined to encompass trade policy, infrastructure, and customs and trade facilitation. Trade diagnostic work is being carried out in more than 35 countries and is complemented by regional studies that examine issues for several countries at a time. There is a growing

FIGURE 4.10 Distribution of ODA for trade-related activities and infrastructure by region and main category



Source: WTO and OECD, 2004.

Note: These regions were defined using U.N. classification.

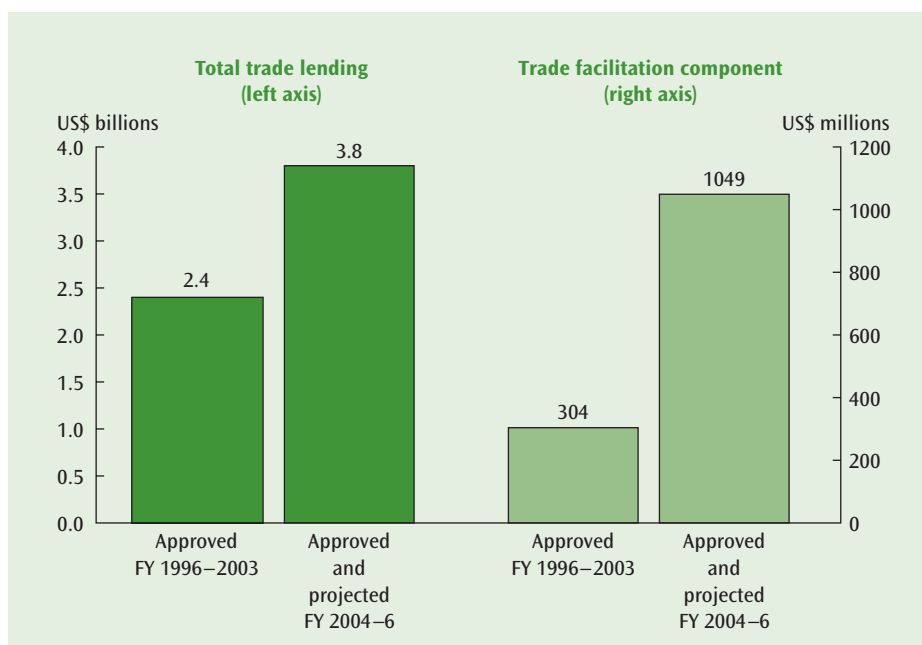
lending program for trade-related activities (figure 4.11). Projected commitments for new trade operations between fiscal 2004 and 2006 are significantly larger than in previous years, with trade facilitation lending being a major growth area.

Trade policy has been a frequent component of programs supported by the International Monetary Fund (IMF). In April 2004 concerns about the balance of payments impacts of trade policy changes motivated the introduction of the Trade Integration Mechanism. Although the core of the IMF's mandate involves support for orderly external adjustment in the face of shocks, the mechanism provides added assurances and represents the first explicit attempt to help members adjust to shocks that emanate from multilateral trade liberalization. The mechanism is designed to help mitigate the stated concerns (by many developing countries) that implementation of WTO agreements might give rise to temporary balance of payments shortfalls—through the erosion of tariff preferences, adverse changes in the terms of trade

of net food importers, or expiration of quotas following full implementation of the WTO Agreement on Textiles and Clothing. In July 2004 Bangladesh became the first member to obtain support from the Trade Integration Mechanism, followed in January 2005 by the Dominican Republic.

These activities reflect the growing recognition that trade-related reforms and infrastructure—both hard and soft—can have high rates of return in increasing economic growth rates. Realizing an ambitious Doha Round and addressing trade capacity priorities in poor countries calls for more to be done. Not only will the associated trade and related reforms give rise to adjustment costs, but to enhance the benefits for poor households in poor countries, as argued previously, investments are needed to facilitate trade, lower transport costs, link farmers and producers to markets, and improve productivity. Strengthening “aid for trade” mechanisms to pursue this agenda would help improve the development relevance of both the WTO and regional integration agreements. An expanded alloca-

FIGURE 4.11 Bank trade-related lending



Source: The data comes from the Bank's Business Warehouse, which consolidates information recorded in SAP and other Bank Systems.

tion of aid for trade would also help build support for the gradual elimination of discriminatory tariff preferences. Indeed, such support is likely to be a precondition for attaining an ambitious Doha outcome that benefits all developing countries.

In considering options for expanding financial support for trade adjustment and integration, two issues are particularly pertinent: the “additionality” of aid resources and the operational framework through which additional funds are made available. Additionality may be achieved by recognizing that the Doha Round, especially an ambitious one, will generate substantial gains for the world as a whole, and that much of these gains will accrue to developed countries. The potential gains create an opportunity for donor countries to consider transferring an increment of the net gain from trade liberalization to help address adjustment costs and improve trade capacity in developing countries. Various options could be considered in this connection, in addition to more official development assistance and stronger public-private partnerships: a commitment to transfer a proportion of the tariff revenue currently collected on imports from developing countries, capturing some of the consumer gains resulting from lower agricultural support for specific products, or partial reallocation of current subsidies and income support to development assistance.⁵³ In all such cases explicit earmarking of additional funding for trade is not desirable—instead the goal would be to establish a framework to commit to redistributing some of the gains from global trade reforms.

The operational framework for allocating aid for trade must ensure harmonization of donor efforts (bilateral and multilateral) and place assistance for trade reform, adjustment, and competitiveness within the broad context of a country’s development program. The attention given to the trade and investment agenda in a country’s national development strategy depends on many factors. Whether trade capacity and trade policy reforms should be given greater priority is a decision for gov-

ernments. To determine this requires that trade be considered when designing national development and poverty reduction strategies. Progress has been made in this direction and continues to be pursued, but much more can be done to better integrate trade considerations into this process. Equally important, demands for funding to address trade and supply capacity constraints need to be met by the donor community in instances where trade is considered a priority and requests for assistance have been put on the table.

The institutional mechanism to identify priorities and allocate additional aid for trade could build on the Integrated Framework for Trade-Related Technical Assistance. This mechanism has already been established, piloted, and subjected to external evaluation, and has broadly based donor and recipient support. The framework is a unique collaborative venture between 6 multilateral agencies—the IMF, International Trade Centre, United Nations Conference on Trade and Development, United Nations Development Programme, WTO, and World Bank—17 bilateral donors, and LDC governments. The primary objective is to integrate assistance in alignment with national development strategies and priorities (including poverty reduction strategies), based on diagnostic country studies and national consultations. Demand for the framework’s trade assessments is high—14 LDCs have completed the assessments and another 14 are under way or planned.⁵⁴

Progress in subsuming the Integrated Framework’s recommendations into country growth strategies has been slower than anticipated. Without additional assistance, over time, legitimate questions can be raised about the efficacy of the program in providing a more effective enabling process of integration with the global trading system. The dedicated resources associated with the Integrated Framework have been limited to small-scale technical assistance. Funding for trade priorities is considered in the context of the poverty reduction strategy resource allocation and prioritization process, with donor

assistance (grants) complemented by loans and other support from international financial institutions and regional development banks. While that should continue to be the case, the Integrated Framework could be used more extensively to both bolster the trade capacity of poor countries and help address the adjustment costs from an ambitious Doha Round. To do so, consideration should be given to expanding the framework's reach beyond LDCs to include other low-income countries and consider regional trade cooperation priorities. (In Africa, for example, members of regional integration initiatives span both LDCs and non-LDCs.) Given the strong case for additional funding to meet trade adjustment and integration costs, building on the Integrated Framework could improve aid effectiveness in the trade area and ensure that identified trade priority projects are implemented.

Leveraging Regional Integration as a Tool for Development

Regional agreements among neighboring developing countries can help lower trade transaction costs and remove policy barriers to intraregional trade. Achieving this is particularly important for landlocked economies that must transport goods through neighboring countries. The agenda extends beyond tariffs and nontariff barriers imposed at borders—it includes regulatory cooperation and joint provision of infrastructure to facilitate trade. South-South integration can also play a beneficial role in helping to create the preconditions for agglomeration, clustering, and the linkages that are critical in diversifying productive activities and sustaining growth.

In Africa in particular, there is a strong regional dimension to growth, absorptive capacity, and the widening of the economic space needed to lower infrastructure costs and facilitate trade. This goes well beyond the trade agenda narrowly defined and includes improving natural resource management and increasing energy supplies and reliability. In terms of absorptive capacity, regional inte-

gration provides a means to increase aid flows in order to open markets and enhance growth prospects in developing countries. Some poor African countries are too small to raise savings for investment on their own, improve growth given limited national markets, or effectively absorb large aid flows for infrastructure. A regional strategy—such as that foreseen by the New Partnership for Africa's Development (NEPAD), revolving around improving policies and governance and developing regional programs for groups of countries to cooperate on infrastructure (power, roads, transportation)—can do much to increase the capacity of the countries concerned to effectively use greater aid flows. As discussed in a number of recent studies,⁵⁵ narrow trade agreements between developing countries have limited potential to foster economic growth, because preferential liberalization of trade policies offers substantial scope for costly trade diversion. For regional integration to be beneficial, external barriers must be low.

North-South agreements can help provide both a focal point for behind-the-border trade reforms in developing countries and mechanisms through which to engage stakeholders and policymakers in the design and implementation of reforms. Because they require trade liberalization by their developing country members, such agreements can also help reduce trade diversion created by South-South agreements among the countries concerned. They also create more opportunities for economic benefits to be realized given larger Northern markets and higher income levels.

Preferential trade agreements revolve around trade discrimination: this is an explicit objective. Because global development prospects are best served by nondiscrimination,⁵⁶ from a development perspective the best outcome would be if regional agreements promoted the principle of nondiscrimination. Achieving this is a major challenge given that the driving force of trade agreements is in part mercantilist—improving (preferential) access to markets. This specific challenge is an illus-

tration of a more general one: to change the modus operandi of designing and implementing trade agreements to place development (economic efficiency and equity) considerations more at the center of deliberations.

Agreements that the European Union and United States are negotiating with developing countries can do much good if designed in a way that puts development first. The ongoing Economic Partnership Agreement (EPA) negotiations are the most important in terms of scale and country coverage, but Japan, the United States, and other large traders are also negotiating agreements with other developing countries.⁵⁷ Taking development seriously in such negotiations has a number of implications, including identifying the most appropriate form of, and membership in, counterpart regional arrangements, addressing trade barriers with neighboring countries, and identifying actions to reduce trade costs—something of great importance for landlocked countries.⁵⁸ Perhaps most important in the context of EPAs and Africa is to avoid trade diversion costs and attenuate tariff revenue losses associated with a move to reciprocal free trade with the European Union.⁵⁹ If African, Caribbean, and Pacific partner countries maintain current levels of protection against the rest of the world, the effect of moving to free trade with the European Union will be to transfer part of what is now collected in revenue on imports to EU producers in the form of higher prices. This points to the importance of complementing reciprocal liberalization with reductions in external barriers to trade, as well as effective assistance to facilitate trade and improve services and related behind-the-border regulation. Pursuit of nondiscriminatory tariff liberalization by developing countries where such barriers are still significant would be better than full preferential liberalization relative to the developed partner only. Many Sub-Saharan African countries still rely on import duties for a significant portion of government receipts, so revenue concerns and the ability to implement alternative revenue sources are a factor influencing the speed of liberalization.

The policy agenda confronting developing countries at the regional level is similar to that at the multilateral level: in both cases much of the challenge is to use these instruments to help address specific national and foreign trade constraints. A major difference is that in the case of regional agreements, reducing external barriers is important to reduce trade diversion. Another difference is that in the case of North-South agreements there may be significant development assistance commitments associated with the implementation of agreements. Allocating and channeling such aid for trade through a multilateral mechanism—such as the Integrated Framework—would ensure explicit recognition that the trade agenda is (and should be) largely a national, country-specific one, and that technical and financial assistance should be directed toward trade-related areas identified as priorities by countries.

Notes

1. WTO and OECD (2004).
2. World Bank (2001).
3. In 2003 shares in global GDP for all LDCs, African LDCs, all low-income countries, and African low-income countries were 0.5, 0.3, 3.4, and 0.6 percent, respectively.
4. The measure of concentration reported here is the Herfindahl-Hirschmann index (the sum of squared shares).
5. World Bank (2004a).
6. World Bank (2004a) provides a comprehensive discussion of the ongoing proliferation of regional trade agreements.
7. These are reportedly specific taxes, not ad valorem, and thus imply an incentive to upgrade quality (produce higher-value products). These taxes may seem low, but because they apply to all exports (not just exports to restricted markets), they are significant.
8. In a case brought by Australia, Brazil, and Thailand against the EU sugar regime, a WTO dispute settlement panel ruled that a number of aspects of EU sugar policy violated WTO rules, including on export subsidies. African, Caribbean, and Pacific countries opposed the case on the basis that reforms in the EU regime would erode existing preferential access arrangements.

9. The OTRI belongs to the family of trade restrictiveness indexes developed by James Anderson (Boston College) and Peter Neary (University College, Dublin) for the World Bank in the early 1990s. A welfare-based measure was originally developed in Anderson and Neary (1994, 1996); an import volume-based measure was first defined in Anderson and Neary (2003). The OTRI is a theoretically well-grounded measure of protection. It does not suffer from the well-known drawbacks of simple or import-weighted tariff averages, and allows the effects of both tariffs and nontariff measures to be estimated. The methodology used for the measure comprises four steps. First, import demand elasticities by country and by product are estimated at the 6-digit level of the Harmonized System (HS) of commodity classification (some 4,200 product categories). Second, an estimate is made of the impact on imports, again at the 6-digit HS level, of core nontariff barriers (quotas, nonautomatic licensing, minimum prices, and similar policies), measures of a regulatory nature (particularly technical, product-specific regulations, and sanitary and phytosanitary measures), and domestic support granted to agriculture. Third, using these demand elasticity and impact estimates, the product-level ad valorem equivalent of the nontariff measures and agricultural subsidies is calculated for each country in the sample. Finally, tariffs and ad valorem equivalents of nontariff policies at the product level are aggregated to produce an overall measure of trade restrictiveness. The index is calculated bilaterally for every country and its partners. The OTRI calculations use the most recent measures of applied preferential tariffs—both reciprocal and nonreciprocal—as well as ad valorem equivalents of specific tariffs. In both instances the source of these data is the Centre d'Etudes Prospectives et d'Informations Internationales (CEPII, France). It is assumed that tariff preferences are fully utilized by eligible countries and that any associated rents accrue to the exporting countries. As discussed below, however, in practice a significant share of such rents often accrues to the countries providing preferential access.

10. The statistical robustness of these relationships is not strong, especially for own trade restrictiveness imposed on imports. Removing just a small number of (outlier) countries results in the relationship either disappearing or becoming a negative association—that is, more protection is associated with less poverty. The relationship

between OTRIs on exports and poverty is stronger (both the coefficient and its statistical significance).

11. See Nicita (2004c) on Mexico and Porto (2003) on Argentina, as well as the Africa-specific work summarized below. Hertel and Winters (2005) contains a review of recent evidence.

12. That is, 32 percent of the gross receipts of farmers were generated by transfers from consumers and taxpayers (OECD 2004).

13. Relative to the *Global Monitoring Report 2004*, the OTRIs reported here are higher on average due to the inclusion of information on mandatory product standards. These were not included in last year's report due to an absence of data for EU members in the UNCTAD TRAINS database. Such data were collected in preparation for this report. Detailed information, including OTRIs by country that use tariff data only, and welfare-based measures of trade restrictiveness, can be found at www.worldbank.org/trade; click on Data & statistics.

14. See Sykes (1995).

15. Whether the intent of these measures is protectionism or based on sound scientific evidence is an important question, but one that is difficult to address. Does the ban on hormone beef imports or restrictions on genetically modified food products in Europe have a protectionist element? Is the ban on Iberico ham “pata negra” or on some types of French epoisse cheese in the United States protectionist? Are they legally and scientifically defensible on health grounds? The answers to these questions will clearly vary depending on which side of the Atlantic they are asked, influenced by risk perceptions and attitudes of those who answer, regulatory requirements, and so on. The OTRI simply measures the impact that these policies have on imported quantities and prices.

16. It is not possible to make clear-cut distinctions in the data between discriminatory and regulatory measures. Even so-called core nontariff barriers identified in the UNCTAD database—such as nonautomatic licensing—may be used as a measure to enforce regulatory requirements.

17. This comprises trade as defined by the WTO General Agreement on Trade in Services (GATS).

18. These preference regimes generally target the LDCs, which are a subset of the broader low-income group. Note also that many African countries are not LDCs.

19. As discussed below, this conclusion regarding the relative impact of subsidies on global prices is supported by both partial and general equilibrium

analysis. See Hoekman, Ng, and Olarreaga (2004); Anderson, Martin, and van der Mensbrugghe (2005); and Hertel and Keeney (2005).

20. Argentina is an example of a country that is significantly affected by OECD agricultural subsidies—they account for about half of the OTRI it confronts in the EU market.

21. Minot and Daniels (2002).

22. Baffes (2004).

23. Sumner (2005).

24. Anderson, Martin, and van der Mensbrugghe (2005); Hertel and Keeney (2005).

25. For example, Walmsley and Winters (2003) conclude that allowing inflows of service suppliers (natural persons) equivalent to 3 percent of the labor force would generate global (static) gains of more than \$300 billion. Estimates of global gains from deep liberalization that include induced productivity effects and services liberalization exceed \$1 trillion (Anderson 2004a; Anderson, Martin, and van der Mensbrugghe 2005) and range to up to \$2.1 trillion (Brown, Deardorff, and Stern 2003). The extent to which such gains can be realized depends on complementary actions being taken to improve the investment climate and business environment so as to allow factors of production to be allocated to their most productive uses, markets to clear, and so on. This “behind-the-border” complementary agenda will require investment and is an area where development assistance can play an important role in allowing countries to capture the potential dynamic gains from trade.

26. Anderson, Martin, and van der Mensbrugghe (2005).

27. Hoekman, Ng, and Olarreaga (2004); Hertel and Keeney (2005, table 2.7).

28. Anderson, Martin, and van der Mensbrugghe (2005).

29. The potential loss can be reduced by requiring any product with a bound tariff in excess of 200 percent to be reduced to the cap rate. See Anderson, Martin, and van der Mensbrugghe (2005).

30. Sumner (2005); Baffes (2004).

31. Hoekman, Nicita, and Olarreaga (2005).

32. Based on estimates reported in Franco, van Meijl, and van Tongeren (2005).

33. This is larger than the \$80 billion found by Hertel and Keeney (2005) using a static computable general equilibrium (CGE) model and the latest GTAP database (which also includes preferences) because of the greater disaggregation of products.

34. Anderson, Martin, and van der Mensbrugghe (2005).

35. WTO (2004).

36. These are mostly confidential; only some countries have derestricted them.

37. Nicita (2005).

38. Balat, Brambilla, and Porto (2004).

39. Balat, Brambilla, and Porto (2004).

40. Nicita (2004b).

41. Regarding cereal and particularly rice, which are largely produced and consumed in Madagascar, predicted price increases following an ambitious Doha Round would have mostly neutral effects from a poverty perspective because the poorest households are both producers and consumers of rice. An increase in the price of rice would likely produce a redistribution of income between geographic areas, with rural areas benefiting at the expense of urban areas. Given that Madagascar is a net importer of rice (although only 7 percent of consumption is imported), an increase in the price of rice would have a small negative effect on overall welfare.

42. Similar conclusions emerge from other LDC country case studies undertaken as background research for the MDG taskforce report on trade (Soloaga 2004), as well as a number of recent country cases collected in Hertel and Winters (2005).

43. Previous reports, including the *Global Monitoring Report 2004*, have argued that trade has significant potential to help achieve poverty reduction and support higher growth rates. As noted in those reports, however, trade offers an opportunity, not a guarantee. Realization of significant reductions in poverty rates is dependent on functioning markets, linking farmers to markets, and so forth. Dealing with the complementary “behind-the-border” and investment climate agenda is critical.

44. OECD (2005).

45. The Global System of Trade Preferences (GSTP) was established in 1988 as a framework for negotiations aimed at the exchange of trade preferences. It is based on (differentiated) reciprocity—that is, is not unilateral.

46. Recent research suggests that rules of origin generate costs on the order of 3–5 percent of the value of the goods (Brenton 2003; Anson and others 2003). Given that many MFN tariffs in OECD countries are less than these levels, this has obvious implications for the effective value of tariff preferences. Candau, Fontagne, and Jean (2004) find that underutilization is highest in textiles and clothing (for EU imports under both the Global

System of Preferences and Everything But Arms programs). In the case of the Everything But Arms initiative, exporters in principle benefit from 100 percent duty-free access, but are found to pay up to 6.5 percent average tariffs. The authors also find that the utilization of trade preferences is lower when the preferential margin is small, suggesting that compliance costs (rules of origin) are a factor.

47. See Olarreaga and Özden (2004) on the Africa Growth and Opportunity Act, Özden and Sharma (2004) on the U.S. Caribbean Basin preference program, and Tangermann (2002) on agricultural preferences in general.

48. Stevens and Kennan (2004).

49. IMF (2003) estimates the potential loss from preference erosion resulting from a 40 percent cut in protection in the Quad at 1.7 percent of total LDC exports. However, individual LDCs may suffer bigger losses due to the concentration of their exports in products that enjoy deep preferences. Of these, Cape Verde, Haiti, Malawi, Mauritania, and São Tomé and Príncipe are the most vulnerable to preference erosion. The total (aggregate) value of export revenue that would be lost by LDCs as a whole is estimated at some \$530 million—similar to the \$600 million figure found by Limão and Olarreaga (2005). This assumes that preferences are fully utilized and that developing countries get all the associated rents, so this is an upper bound. Alexandraki and Lankes (2004), focusing on middle-income countries, conclude that potential erosion impacts are less than 2 percent of total exports for countries that are most “preference dependent.” Six countries—Belize, Fiji, Guyana, Mauritius, St. Kitts and Nevis, and St. Lucia—would be significantly affected, with predicted export

declines ranging from 7.8 percent for Fiji to 11.5 percent for Mauritius.

50. Winters (2004).

51. WTO and OECD (2004).

52. Examples mentioned in WTO and OECD (2004) include a regional trade facilitation program of the United Kingdom that aims to increase trading opportunities for small-scale farmers and traders through the development of common standards across goods and services and the streamlining of customs procedures in Southern Africa. Another example is France’s regional program that aims to develop “fair trade” in Africa. Increases in trade development activities have centered on regional programs, such as an International Development Association (IDA) credit to assist the development of power exports between Southern African countries and an EU multisector small and medium-size enterprise development project in Latin America.

53. Hoekman (2005a); Prowse (2005).

54. For information on the Integrated Framework and the status of its activities, go to www.integratedframework.org.

55. Schiff and Winters (2003); World Bank (2004a).

56. World Bank (2004a).

57. World Bank (2004a).

58. These issues are discussed at greater length in Hinkle and Newfarmer (2005) in the specific case of the EPAs. For example, the form of African, Caribbean, and Pacific agreements is an issue because a customs union—the preference of the European Union—may be difficult to implement given overlapping regional agreements in Africa and the need to develop revenue sharing mechanisms.

59. Hinkle and Schiff (2004).

Increasing Aid and Its Effectiveness

Developed countries can help developing countries achieve the Millennium Development Goals (MDGs) by providing more and better aid. Development assistance can ease the short- and medium-term resource constraints facing poor countries, enabling them to make much-needed investments in infrastructure and social services. In many low-income countries, especially in Sub-Saharan Africa, aid dominates external development flows. Accordingly, these countries are particularly dependent on higher levels of assistance if they are to achieve the MDGs—and are more vulnerable to aid shortfalls. The issue that arises is whether aid can be scaled up effectively in countries that need it most. Low-income countries that implement sound economic policies, strengthen institutions, and pursue good governance can absorb additional aid rapidly and effectively.

How aid is allocated and delivered is as important as its volume for achieving the MDGs. Aid is more effective in fostering growth and improving service delivery in countries with better policies and institutions. It is also more effective when it is aligned with recipients' priorities, when it reduces transaction costs through harmonized and coordinated donor processes, when it is predictable, and when there is a clear focus on results.

As a result of the 2002 United Nations Conference on Financing for Development in Monterrey, Mexico, donors committed to providing more—and more effective—aid. What progress has been made? The recovery in official development assistance (ODA) that started in 2001 is continuing, but recent levels and near-term projections fall far short of what is needed to meet the MDGs. Among members of the OECD's Development Assistance Committee (DAC), ODA as a share of national income remains low relative to the 1990s and before. Moreover, much of the recent increase in bilateral ODA reflects donor concerns about regional and global security. Donor attention to geopolitically significant countries appears to be crowding out assistance to countries that need the most help in achieving the MDGs. A better balance is needed between poverty reduction and other donor objectives. Aid policy should reflect the growing recognition that reducing poverty and human deprivation is perhaps the most effective way of promoting long-term peace and security.

Although the proportion of aid going to Sub-Saharan Africa is rising, much more could be done. On average, ODA equaled 6.2 percent of recipients' GNI in the region in 2003—high relative to other regions, but below the levels of the early 1990s. Most of

the \$8.5 billion nominal increase in bilateral ODA to Sub-Saharan Africa between 2001 and 2003 was in the form of debt relief; program and project assistance grew by just \$0.6 billion. While debt relief helps relieve problems associated with heavy debt burdens and creates fiscal space, it is not enough. Substantial increases in program and project financing are needed as developing countries scale up their efforts to achieve the MDGs. Sub-Saharan countries have seen a decline in ODA for infrastructure and rural and agricultural development. Investments in these countries' social sectors have also been inadequate (see chapter 3). Large shortfalls in financing for these sectors—which are key to spurring growth and scaling up MDG-related services—point to the need for much higher ODA.

Discussions continue on proposals to augment higher aid flows with innovative financing mechanisms, such as the International Finance Facility, global taxes, voluntary mechanisms, and blending arrangements. The International Finance Facility, proposed by the U.K. Treasury, is designed to frontload aid flows in the short term to help reach the MDGs. In addition, a wide range of proposals has been made on ways to raise additional resources through new global tax instruments. If technical and political challenges can be resolved, global taxes could complement the International Finance Facility, generating additional aid funds in the medium to long term, when flows under the facility would diminish.

Policies and institutions in developing countries continue to improve, promoting a better enabling environment for scaling up aid. Although low-income countries as a group can effectively absorb much more aid, the amount varies by country. A number of countries could manage a doubling of assistance in the short to medium term, but capacity constraints pose a significant obstacle in countries with weak policies and institutions. In all cases a country-specific approach, anchored in a poverty reduction strategy (PRS) framework, is required to assess exter-

nal financing needs, identify and address capacity constraints, and appropriately sequence incremental financing. Absorptive capacity is a dynamic concept, so even though capacity may be limited today, it can be built over time—and aid can play an important role in that as well.

Donors are allocating more aid to better performers—those with stronger policies and institutions—and to poorer countries. But there is considerable variation among donors, and some large donors are not very selective on these dimensions. A sharper performance-based focus by these donors could strengthen the overall quality of aid. Increasing attention is being paid to the special needs of difficult partnership countries (including low-income countries under stress), which receive less aid than predicted by their policy and institutional environments and poverty levels. Thus a modest increase in aid to this group might be possible without compromising the performance basis of aid. Recent evidence also suggests that well-coordinated and appropriately sequenced and directed aid can be effective in supporting the recovery of countries from conflict and from situations of exceptionally weak policies and governance. Appropriate and adequate support for capacity building is a priority in these situations.

Progress on harmonization and alignment has been mixed, and that on managing for results is just beginning. The 2003 High Level Forum on Harmonization in Rome and the 2004 Roundtable on Managing for Development Results in Marrakech strengthened the focus on aligning donor assistance with recipients' national strategies and priorities as articulated in PRSs or equivalent national strategy documents, harmonizing donor processes and procedures with those of partner countries, and managing aid programs for development results. Yet efforts to implement good practices in these areas have been slow and uneven. Progress on harmonization and alignment is most evident in countries where governments have worked longest and hardest to take ownership of the aid process. Some early progress on managing for results

is also evident, as the development community moves toward implementing the results agenda. Participants at the March 2005 High Level Forum on Aid Effectiveness in Paris reaffirmed their commitment to the global agenda on harmonization, alignment, and results. The forum's Paris Declaration defines 12 indicators for monitoring reforms of aid delivery and management.

The potentially large financing needs associated with the MDGs pose a challenge to low-income countries in maintaining sustainable debt positions. The enhanced Heavily Indebted Poor Countries (HIPC) initiative has lowered debt burdens for participating countries: 27 countries have reached their decision points and are receiving debt relief, and 15 of these have reached their completion points—when creditors provide the full amount of debt relief committed at the decision points. Nevertheless, continued measures are needed by HIPCs and their creditors to ensure that financing the MDGs will not lead to excessive buildup of new debt. This issue of debt sustainability is not limited to HIPCs; it extends to other low-income countries with existing or prospective debt pressures. The World Bank and International Monetary Fund (IMF) are developing a forward-looking debt sustainability framework for low-income countries that incorporates systematic analysis of the evolution of key debt burden indicators (under baseline assumptions and in the event of plausible shocks) and that establishes indicative thresholds for these indicators, based on the quality of a country's policies and institutions. In addition, G-7 members have recently offered a number of new proposals, beyond the HIPC initiative, for debt relief to low-income and highly indebted countries.

Looking ahead, there are numerous priority areas for action on aid:

- Donors need to implement their post-Monterrey commitments and substantially raise and extend them beyond 2006—say, to 2010—with a view to at least doubling ODA in the next five years. While several

countries have committed to expanding aid efforts beyond 2006, half of DAC members have not, including some of the largest donors. They should do so in 2005.

- PRSs should provide the framework for scaling up aid—assessing financing needs, identifying and addressing capacity constraints, and appropriately sequencing incremental financing. Where absorptive capacity is an obstacle to scaling up, aid can still be effective by focusing on building capacity and improving service delivery through innovative mechanisms.
- Donors need to further sharpen their focus on providing aid to better-performing poor countries. For their part, recipient countries should expedite efforts to enhance their capacity to make effective use of incremental aid flows.
- Donors need to address more effectively the special needs of difficult partnership countries (including low-income countries under stress), exerting greater efforts to better coordinate, align innovatively, and sequence aid.
- Progress on implementing the harmonization, alignment, and managing for results agenda should be accelerated. Bottlenecks to progress—captured in the 12 indicators defined by the Paris Declaration—need to be addressed by donor and partner countries, and continued focus at the highest levels in these countries will be required to accelerate change. Developing countries need to take more ownership of the aid harmonization and alignment process. And donors need to encourage and support this process, especially through capacity building.
- On debt relief, continued effective implementation of the HIPC initiative remains key. On proposals for additional debt relief for poor countries with heavy debt burdens that are pursuing credible reforms, efforts should be made to reach closure in 2005. Additional debt relief should not cut into the provision of needed new financing, which for these countries should primarily be in the form of grants.

Recent Trends in Aid

Despite positive trends, donors' recent aid efforts lag those of the early 1990s. And though donor commitments announced at and after the Monterrey conference point to the prospect of higher aid, far more is needed. Moreover, much of the recent increase in development assistance reflects donors' strategic concerns. Only a modest amount is available in cash and more flexible forms to meet countries' financing requirements for the MDGs. Thus far more aid is needed to meet the MDGs, and a better balance is needed between donors' poverty reduction and other objectives.

As with overall ODA, flows to Sub-Saharan Africa have been rising. Aid dwarfs other sources of foreign financing for the region, underscoring its importance. Still, a major increase in aid will be required if the region is to achieve the MDGs.

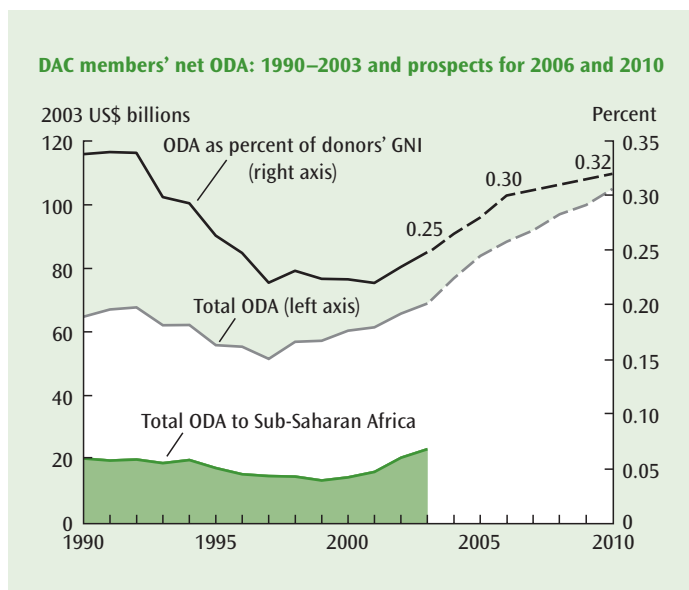
Aid—Rising But Insufficient for MDG Needs

The recovery in ODA that started in 2001 is holding as donors deliver on post-Monterrey

aid commitments.¹ Development assistance increased by 5 percent in real terms in 2003, down from 7 percent in 2002. Taking into account exchange rate movements and inflation, which accounted for nearly \$8 billion of the increase, nominal ODA rose by almost \$11 billion in 2003, to \$69 billion. Preliminary OECD DAC estimates indicate that net ODA rose to \$78.6 billion in 2004; the increase in real terms was much smaller—to \$72.2 billion (at 2003 prices and exchange rates). If announced aid commitments are delivered, ODA is expected to grow by nearly 30 percent in real terms between 2003–6 and could rise to more than \$100 billion by 2010 (figure 5.1).² Several countries have committed to higher aid efforts beyond 2006, the target date for the commitments made at the Monterrey conference, but some of the largest donors have not done so.

Despite the progress in expanding ODA since Monterrey, donors' aid efforts lag behind those of the early 1990s and before.³ At 0.25 percent in 2003, ODA as a share of donors' average gross national income (GNI) was three-quarters the level in the 1970s, 1980s, and early 1990s, and only about half the level in the 1960s.⁴ Five countries—Denmark, Luxembourg, the Netherlands, Norway, and Sweden—have achieved ODA shares of 0.7 percent of GNI or more (figure 5.2), and six—Belgium, Finland, France, Ireland, Spain, and the United Kingdom—have announced timetables for achieving that level. Implementation of such pledges will be vital to raising aid flows to poor countries; the target of \$5 billion in annual assistance by fiscal 2006 under the U.S. Millennium Challenge Account is now unlikely to be reached until fiscal 2007 (box 5.1). Even on announced pledges, DAC donors' aid effort is expected to reach only 0.3 percent of GNI by 2006 and 0.32 percent by 2010, below the level of the early 1990s. Among the actions being considered by the European Commission is the setting of new—and higher—interim targets for ODA relative to members' GNI for the period beyond 2006, with the goal of reaching the target of 0.7 percent as soon as possible.⁵

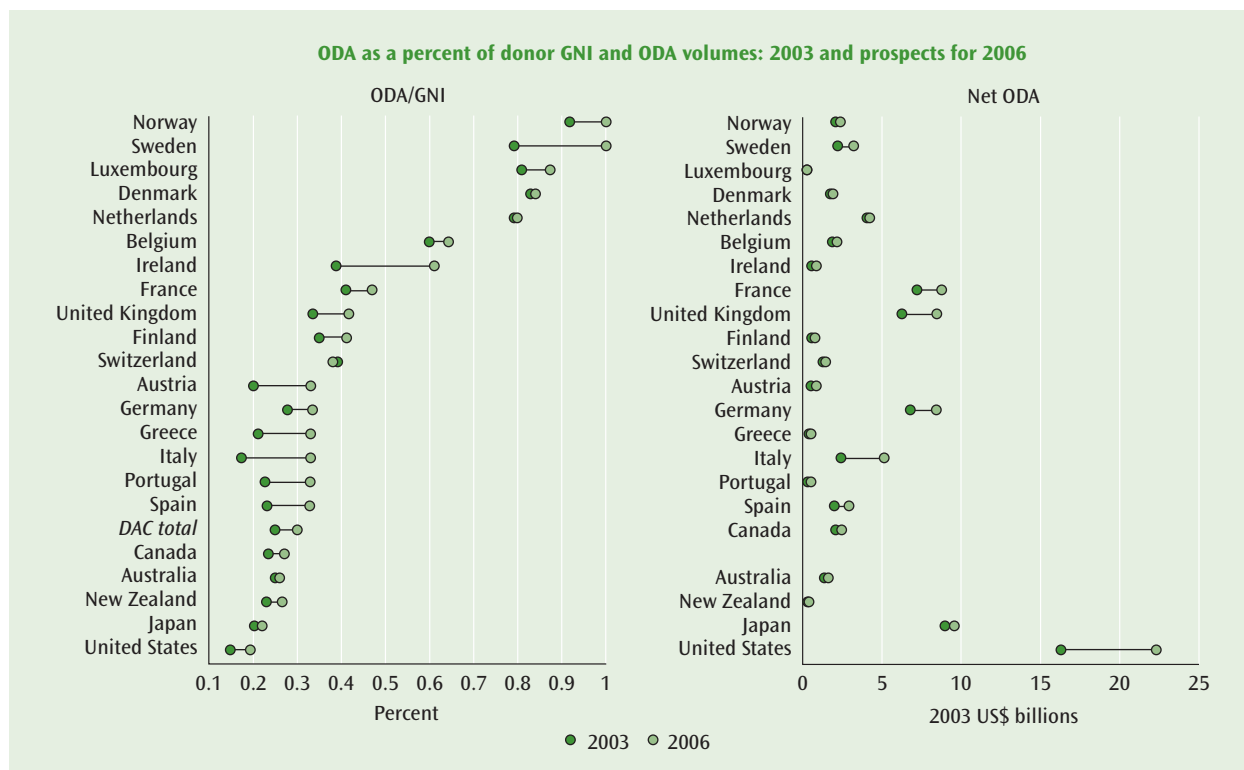
FIGURE 5.1 ODA is rising but is well short of what is needed; donors need to raise their post-Monterrey commitments and extend them beyond 2006



Source: OECD 2005a.

Note: Prospects for ODA in 2006 and 2010 are based on DAC members' post-Monterrey announced commitments. Not all DAC members have made commitments beyond 2006.

FIGURE 5.2 Wide variation in donor effort



Source: OECD DAC database.

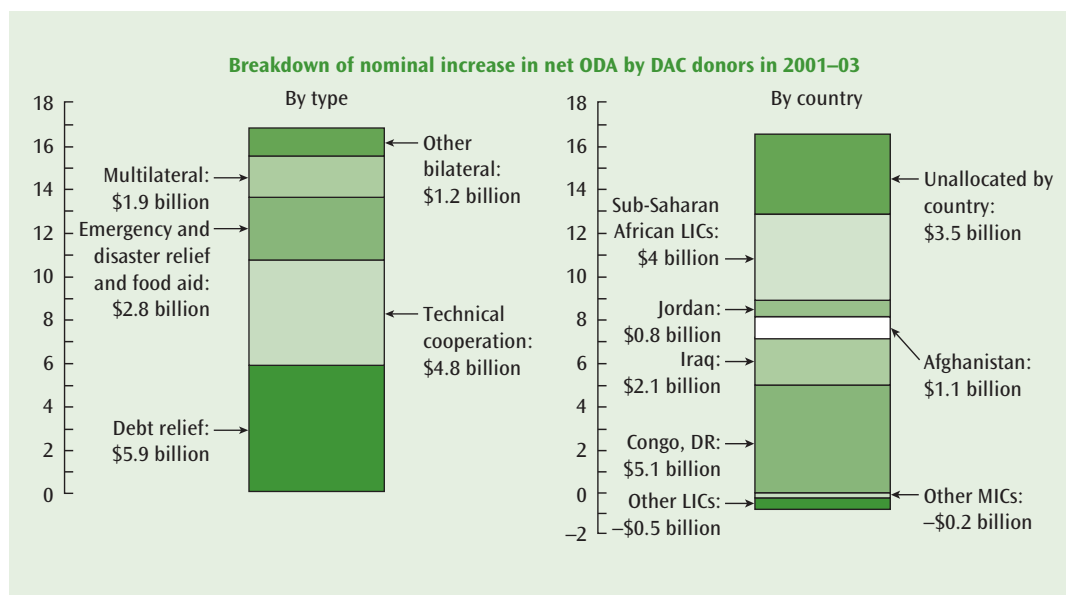
BOX 5.1 The U.S. Millennium Challenge Account—poised to deliver

The Millennium Challenge Account (MCA) is a new bilateral aid mechanism, announced by the United States at the Monterrey conference and established in January 2004. It allocates new U.S. aid to poor countries based on their performance in three policy areas: governing justly, investing in people, and promoting economic freedom. To date, 17 countries are eligible to apply for MCA assistance. In addition, a threshold program encourages policy reform by offering 13 other countries help in areas where they fall short of qualifying for the MCA.

MCA-eligible countries identify their own priorities and develop their own MCA proposals, based on their assessments of the greatest barriers to their development and in consultation with civil society and the private sector. The Millennium Challenge Corporation evaluates MCA proposals based on their potential for reducing poverty through sustainable economic growth. The proposals are not restricted to any particular sector or area. MCA countries join with the Millennium Challenge Corporation in multiyear compacts to achieve shared development objectives. The compacts identify the responsibilities of each partner and contain clear objectives, benchmarks to measure progress, procedures to ensure fiscal accountability for the use of MCA assistance, and plans for effective monitoring and objective evaluation of results. Programs are designed to enable progress to be sustained after funding under the compacts has ended.

The initial target envisioned \$5 billion in annual assistance under the MCA by fiscal 2006. The U.S. administration's fiscal 2006 budget request of \$3 billion doubles the 2005 appropriation and envisions expansion of MCA funding to \$5 billion in fiscal 2007. The Millennium Challenge Corporation approved the first MCA compact in March 2005, with Madagascar (providing nearly \$110 million for a four-year project), and disbursements are expected to begin in spring 2005.

Source: Millennium Challenge Corporation 2003, 2005.

FIGURE 5.3 Debt relief and technical assistance dominate the increase in ODA

Source: OECD DAC database.

Note: Total nominal increase in DAC members' net ODA in 2001–3 was \$16.6 billion. The corresponding real increase was \$6.6 billion in 2002 prices and exchange rates. Sub-Saharan African LICs does not include the Democratic Republic of Congo.

Again, donors need to commit to expanding aid efforts beyond 2006, to 2010 or beyond.⁶

Most of the increase in development assistance has been in the form of noncash assistance and debt relief.⁷ Debt relief and technical cooperation accounted for two-thirds of the \$16.6 billion nominal increase in DAC members' net ODA between 2001 and 2003, with \$5.9 billion allocated to debt relief and \$4.8 billion to technical cooperation (figure 5.3).⁸ At about 17 percent, emergency disaster relief and food aid also represented a significant portion of the increase. The increase in these categories cut into the shares of assistance available in cash and more flexible forms—for program and project assistance—to meet countries' financing requirements for meeting the MDGs. For example, bilateral ODA for program and project assistance increased by a modest \$0.6 billion during this period. This category accounted for just a quarter of bilateral ODA in 2003, down from a third in 2001 and well

below the roughly 60 percent average of the 1980s. Debt relief levels will remain high (and rise) in the near term as more countries reach their completion points under the enhanced HIPC initiative, and because of the recent decision by donors to forgive up to 80 percent of Iraq's debt to the Paris Club. Possible additional debt relief to poor countries beyond the enhanced HIPC initiative would also affect the size of this category. While debt relief is crucial to relieving problems associated with high debt burdens and to expanding fiscal space, donors will need to ensure that additional relief does not crowd out needed increases in financing for development (for further discussion, see the section below on debt relief).

Global and regional security concerns have boosted aid flows as well. Aid to Iraq was sharply higher at \$2.3 billion in 2003, up from \$0.1 billion in both 2001 and 2002. Between 2001 and 2003 aid to Afghanistan nearly quadrupled, to \$1.5 billion, and devel-

opment assistance to Jordan tripled. Pakistan received large amounts of net aid in 2001 and 2002 (about \$2 billion a year), but loan repayments on previously rescheduled debt lowered net flows in 2003. In addition, the Dayton Peace Accord countries—Bosnia and Herzegovina, Croatia, and Serbia and Montenegro—continue to receive large amounts of aid, averaging \$2.2 billion a year in 2001–3.

Non-DAC countries contribute significant assistance to developing countries, with such flows reaching \$3.4 billion in 2003, or 5 percent of DAC ODA—more than twice the level in 2001.⁹ Saudi Arabia continued to be the largest donor in this group; its ODA contributions jumped from less than \$500 million in 2001 to \$2.4 billion in 2003. Other non-DAC countries have also rapidly increased their ODA. For example, the Czech Republic more than tripled its development assistance during this period, providing \$91 million in 2003.

Important contributions to development efforts in poor countries are also being made through South-South cooperation, particularly through the sharing of experience and know-how. Comprehensive data on South-South development assistance are not available, but countries such as Brazil, China, and India have been particularly active in providing technical assistance to low-income countries.¹⁰ South-South assistance is expected to grow as these larger economies continue to record impressive economic and technological advances. Grants from nongovernmental organizations (NGOs), using their own resources, also continue to rise. These grants totaled \$10.1 billion in 2003, up from \$8.8 billion in 2002, and are expected to be sharply higher in the aftermath of the recent Asian tsunami.

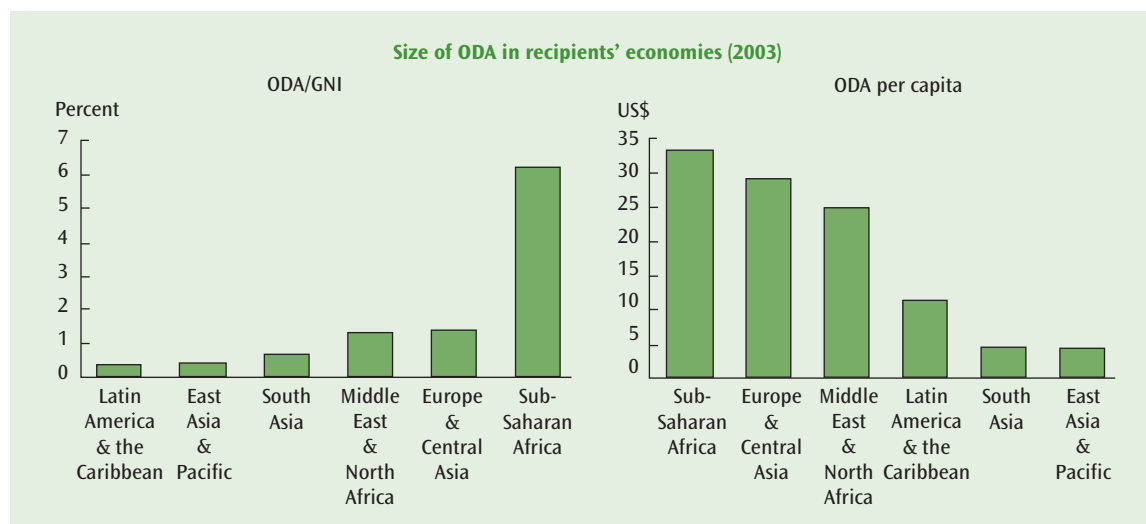
Although multilateral ODA—comprising grants and net concessional lending—has grown in recent years, total multilateral flows to developing countries have declined. Multilateral ODA grew by 7 percent in nominal terms between 2001 and 2003, with higher grants offsetting a decline in net concessional debt flows. Nonconcessional lending by multilaterals, mostly to middle-income countries,

has exhibited considerable variation—reflecting less nonconcessional borrowing from the IMF, repayments on past crisis financing packages, and prepayments of loans to the World Bank.

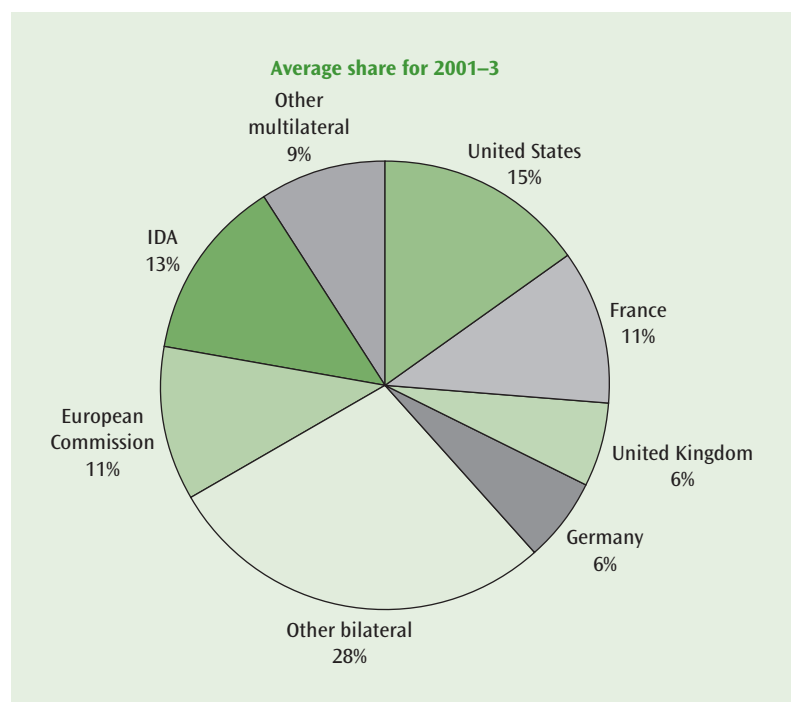
Because of rising incomes in developing countries, higher aid volumes have translated into only a modest rise in the share of ODA in recipients' GNI. Indeed, in 2003 this share is only slightly above the low of 1997 and is expected to remain in a narrow range through 2006. The weight of aid in recipients' economies is largest in Sub-Saharan Africa, averaging 6.2 percent of GNI in 2003—at least four times that in other regions, signaling the importance of aid for Africa (figure 5.4). Globally, per capita ODA edged up in recent years, averaging about \$14 in 2003, though this was below the level of the early 1990s. Again, there was wide regional variation, with Sub-Saharan Africa receiving the most ODA per capita.¹¹

Improving Trend in Development Assistance to Sub-Saharan Africa

Mirroring the recovery in overall ODA, development assistance to Sub-Saharan Africa has begun to rise from its substantial slide of the 1990s. In real terms, aid to the region is higher now than in the early 1990s. The region is also receiving a larger share of net ODA (disbursements): At about \$24 billion, its share of total ODA was 33 percent in 2003, up from 27 percent in 2000. Most aid to the region is in the form of grants—bilateral donors provide nearly all their assistance as grants, and multilateral net ODA consists of highly concessional loans (60 percent) and grants (40 percent). In 2001–3 the United States and the International Development Association (IDA) were the largest donors to Sub-Saharan Africa (with the U.S. share sharply higher in 2003, at 20 percent), followed by France and the European Commission (figure 5.5). Several bilateral donors, such as Belgium, France, Ireland, Italy, and Portugal, allocate more than half of their bilateral net ODA to Sub-Saharan Africa.

FIGURE 5.4 Dependence on aid varies by region and is highest in Sub-Saharan Africa

Source: OECD DAC database.

FIGURE 5.5 Sub-Saharan Africa's largest donors

Source: OECD DAC database.

Note: The shares may not add to 100 because of rounding.

While the positive trend in development assistance to Sub-Saharan Africa is encouraging, the increase in aid provided in cash and more flexible forms—program and project assistance—has been rather modest. Most of the \$8.5 billion increase in net bilateral ODA to the region between 2001 and 2003 was in the form of debt relief (\$5.6 billion) and emergency and disaster relief and food aid (\$1.5 billion).¹² The increase in program and project assistance (in cash) was only about \$0.6 billion.

The increase in total ODA—bilateral and multilateral—to the region was concentrated in a handful of countries. The Democratic Republic of Congo received an additional \$5.1 billion (most of it for debt relief operations), Cameroon \$480 million, Sudan \$436 million, Tanzania \$398 million, and Ethiopia \$389 million.¹³ Other countries in the region received about \$2.5 billion. Although the amount of aid allocated to social services has grown, that to infrastructure and rural and agricultural development has steadily declined.

Although aid to Sub-Saharan Africa is rising, much more will be needed to support its efforts to achieve the MDGs. Again, ODA averages 6.2 percent of recipients' GNI, and while this is high relative to other regions, it is well below the levels of the early 1990s and the estimated needs to meet the MDGs. There is also large variation in aid flows across Sub-Saharan countries. A handful of countries, such as Mozambique and Sierra Leone, have very high aid to GNI ratios. Indeed, in one-sixth of 42 countries in the region, bilateral ODA is equal to more than 10 percent of GNI. Yet in almost as many that share is less than 1 percent. In 1990 the corresponding distribution was nearly 40 percent and 2 percent, respectively.

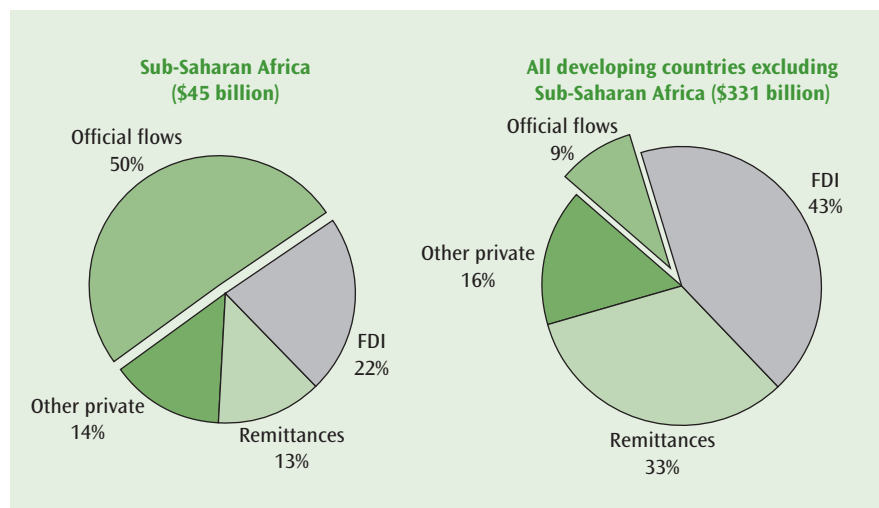
ODA accounts for nearly 55 percent of foreign financial flows to Sub-Saharan Africa (figure 5.6), up from the levels of the late 1990s.¹⁴ Foreign direct investment (FDI) is also a significant source of external finance for the region. In 2003 FDI was equal to 2.5 percent of GNI for Sub-Saharan countries, larger than the share for low-income countries (1.5 percent) and slightly higher than the average for all developing countries (2.3 percent). FDI is concentrated in a few large, resource-rich economies, with more than half going to Angola, Nigeria, and South Africa in 2001–3. In 2003 remittance flows to the region equaled just 1.5 percent of GNI.¹⁵ Remittances are also concentrated in a few countries, with Kenya, Nigeria, and Sudan receiving almost 55 percent of these flows in 2001–3.

Most Sub-Saharan countries have limited prospects for attracting FDI. While many countries have gone through tough reforms to liberalize their economies, promote macro-

economic stability, and rationalize taxes and tariffs, much remains to be done. FDI is strongly influenced by a country's investment climate—and among developing countries, those in Africa have the most regulatory obstacles to doing business.¹⁶

African countries perform especially poorly on the costs of starting a business, enforcing contracts, registering property, and labor regulation flexibility. The costs of a weak investment climate can be substantial. Data from investment climate surveys show that in terms of sales lost, such costs are two to three times larger in Kenya, Tanzania, and Zambia than in Brazil and China. The composition of these costs varies dramatically across countries: in Kenya and Tanzania weak infrastructure services are particularly burdensome, while in Zambia bribes are especially costly. Thus priority areas for reform also vary by country. Other country features, such as small size and geographic location (especially being landlocked), are further constraints to attracting FDI.

FIGURE 5.6 Official flows are the main source of external finance for Sub-Saharan Africa, twice as large as FDI and nearly four times as large as remittances
Financial flows (long-term), 2003



Sources: OECD DAC database; World Bank data and staff estimates.

Note: Official flows include ODA and non-ODA. Although remittances are classified as current transfers in the balance of payments, they are an increasingly important source of foreign exchange for developing countries and are included here as financial flows. Also included are NGO grants, which are current transfers. The shares may not add to 100 because of rounding.

Sub-Saharan countries need to accelerate reforms to enhance their investment climates. They also need to scale up investments in basic infrastructure. Over time, such changes will attract more FDI. But in the near to medium term, increases in ODA will remain critically important for the region.

Innovative Financing Mechanisms to Augment Traditional Aid

In the absence of sufficient traditional ODA, innovative financing mechanisms may be required to increase aid flows. Several proposals are under discussion.¹⁷

INTERNATIONAL FINANCE FACILITY

The International Finance Facility (IFF) is a proposal designed to frontload aid flows in the short term to help countries reach the MDGs. Donors would make off-budget pledges of future increases in aid commitments. The IFF would use the pledges as backing to issue AAA-rated bonds. Bond proceeds would be channeled through existing aid programs. Over time the IFF would draw down the donor pledges to pay off its bonds. Future aid budgets would thus be used to support aid disbursements as and when they are needed in the short term.

Technical aspects of the IFF proposal are being addressed through a pilot IFF for Immunization (IFFIm). This pilot facility would raise frontloaded, reliable funding over a number of years to expand global immunization efforts to help achieve the child mortality MDG.¹⁸ The IFFIm would largely rely on the governance structures and country programs of the Global Alliance for Vaccines and Immunization (GAVI) and the Vaccine Fund.

The frontloaded IFFIm funds would be used for two main purposes: accelerating production of new and existing vaccines, to stimulate private investment and competition and to reduce vaccine costs more rapidly than if there were no scaling up; and strengthening capacity to deliver vaccines to save children's lives immediately, reduce the risk of disease,

and support other health interventions by improving public health infrastructure.

The IFFIm is intended to be a small IFF, and if successful would serve as proof of concept for some aspects of the larger IFF: the capacity to garner donor support for such a mechanism, resolution of issues on the fiscal treatment of contingent donor pledges, and acceptance of IFF-generated AAA bonds by rating agencies and capital markets.

GLOBAL TAXES

A wide range of proposals has been made on ways to raise additional revenue through the introduction of global tax instruments. Global tax proposals should be judged by their revenue adequacy and stability, efficiency, equity, ease of collection, and minimum coalition size. Additionality must also be considered: allocating the proceeds of a tax to development spending may partially or completely displace spending from traditional sources. In addition, detailed aspects of implementation have received relatively little attention.

Increasing international attention on how to move forward on specific mechanisms may lead to more focused work on promising alternatives. One possibility recently put forward in the European Union would be an international airline fuel tax, which would address two externalities: the environmental damage caused by air transportation and the failure of international tax coordination in that airline fuel, unlike any other fuel, is generally untaxed. Such a tax could raise some \$9 billion a year, if levied globally at a rate of \$0.20 a gallon. As another example, it has been estimated that a tax on arms sales could raise \$2.5–5.0 billion a year.¹⁹ If technical and political difficulties can be resolved, global taxes could complement the IFF, generating additional aid funds in the medium to long term as IFF flows, designed to increase development funds in the short term, diminish while its bonds are being repaid.²⁰

VOLUNTARY CONTRIBUTIONS

Private contributions to finance development are increasing. They are made in a range of

ways that could be expanded, encouraged, and made more effective without impinging on their voluntary and private nature. Some mechanisms, such as the establishment of “affinity” credit cards that provide funding for development through voluntary surcharges, could be undertaken by interested banks or companies. Others, such as the creation of a special-purpose global lottery or premium bond, would require regulatory action by participating countries, either unilaterally or acting in concert. Given the relative lack of clear, consistent global data about these flows, the international community could benefit from a more systematic work program to explore what governments can do to encourage private and voluntary flows for development, and to foster their effective channeling and use in support of developing countries’ priorities.

BLENDING ARRANGEMENTS

Blending arrangements—that is, combining flows with different financial terms and characteristics (such as grants, loans, and guarantees) to increase concessionality or gain leverage—are a possible way to augment resources for the MDG agenda, fund global and regional public goods, and address individual country circumstances, such as creditworthiness constraints affecting gap countries.²¹ Blending mechanisms could be structured in a variety of ways to provide different types of funding based on country and program circumstances.

The Need for—and Challenges of—Increasing Aid

Current and near-term projections of development assistance fall far short of what is needed to meet the MDGs. Although recent estimates of the additional resources needed to achieve the MDGs vary widely, they all point to a significant financing gap (box 5.2). At the conservative end of these estimates, ODA must increase by at least \$50 billion a year, with the increases phased in alignment with growth in recipients’ absorptive capacity. The UN Millennium Project projects the additional exter-

nal assistance needed to directly support the MDGs in low-income countries at \$73 billion in 2006, rising to \$135 billion by 2015.²² Financing the MDGs and other needs would require nearly tripling net ODA. Because costing the MDGs is difficult, there is much debate on the amounts needed to achieve them.²³ Still, there is broad agreement that current development assistance is insufficient and that substantially more aid is needed.

At current trends, most developing countries will fall far short of achieving the MDGs for health and education. The financing needs for meeting these goals are large relative to available domestic resources, and significantly higher aid will be needed to fill the financing gap. Adequate progress by developing countries on the health goals, where projected shortfalls are greatest, will require at least \$25 billion a year in additional aid. Additional aid requirements for meeting the primary education goal in low-income countries are estimated to be at least \$3 billion a year (see chapter 3).

Developing countries also need to address serious gaps in infrastructure.²⁴ Annual spending on infrastructure—electricity, transport, telecommunications, water, and sanitation—is about 3.5 percent of GDP in these countries, against estimated needs of about 5.5 percent to reach the MDGs. The shortfall in infrastructure financing is worse in poorer countries. For example, Sub-Saharan Africa needs to double annual infrastructure spending from 4.7 percent to 9.2 percent of GDP (see chapter 2). Ethiopia shows just how large the infrastructure gap is: In 2001 its road density was 0.029 kilometers per square kilometer of land—about a quarter of the average for low-income countries. Scaling up Ethiopia’s road density by a factor of three, as part of a strategy to accelerate progress toward the MDGs, would cost some \$7.2 billion over 2005–15. This amount is more than three times what investment would be if current trends continued. Clearly, many low-income countries do not have sufficient domestic resources or access to global financial markets to finance such investment.²⁵ More aid will be critical to accelerating provision of infrastructure.

BOX 5.2 Estimates of MDG financing needs vary widely, but all point to the need for a major increase

The UN Millennium Project (2005) conducted detailed MDG-based needs assessments for five low-income countries—Bangladesh, Cambodia, Ghana, Tanzania, and Uganda. In Ghana, for example, per capita expenditure needs are projected at \$80 in 2006, rising to \$124 by 2015. The bulk of such spending will have to come from external financing: \$52 in 2006 and \$70 in 2015. (During this period domestic resource mobilization is expected to rise by about 4 percentage points of GDP.) The assessments for the other low-income countries suggest similar external financing needs: \$40–\$50 per capita in 2006, rising to \$77–\$98 in 2015. The study projects the MDG financing gap in low-income countries to be \$73 billion in 2006, rising to \$135 billion in 2015. The gap in middle-income countries is projected to be \$10 billion a year. Meeting the MDGs and other needs in low- and middle-income countries implies additional ODA over 2003 levels of \$66 billion in 2006 and \$126 billion in 2015—a nearly threefold increase in net ODA by 2015. This implies that the share of ODA in donors’ GNI will be 0.44 percent in 2006, rising to 0.46 percent in 2010, and reaching 0.54 percent by 2015.

Several other studies have tried to place a figure on the global cost of meeting the MDGs. These were discussed in detail in the *Global Monitoring Report 2004*, so their results are only summarized here. The range of estimates varies widely, but most point to the need to increase ODA by at least \$50 billion.

The Commission for Africa (2005) estimates that achieving the MDGs in Sub-Saharan Africa will require \$75 billion a year in additional financing. Two-thirds of the increase (\$50 billion) would come from external sources. The Commission recommends proceeding in two stages. In the first stage an additional \$25 billion a year would be required within three to five years (2006–2008/10)—doubling aid to Sub-Saharan Africa over 2004 levels. Implementation of the second stage would be based on an assessment of the improvements in governance and aid quality achieved in the first stage.

Estimates of additional ODA requirements vary widely

Study	Estimate of additional annual ODA required to meet the MDGs
UNMP (2005)	Increase over 2003 of \$66 billion in 2006, \$83 billion in 2010, and \$126 billion in 2015
Development Committee (2003, 2004)	Initial increment of at least \$30 billion (for MDG investment needs), rising to more than \$50 billion
United Nations (2001)	About \$50 billion (to directly support the MDGs)
Commission for Africa (2005)	For Sub-Saharan Africa, \$25 billion (doubling ODA) within 3–5 years, and \$50 billion by 2015

Recent evidence suggests that aid can boost growth if it is invested well, say, in infrastructure.²⁶ A cross-country study also finds that aid that directly supports investment has a positive influence on growth.²⁷ Thus budget support, balance of payments support, and investment in infrastructure and productive sectors like agriculture

appear to have a positive impact on growth in the short term. Aid to social sectors also contributes to growth, but its impact is longer term. Importantly, the case for more aid to education and health, apart from its “narrow” contribution to economic growth, derives from its impact on the nonincome dimensions of poverty.

Absorptive Capacity Constraints to Scaling Up Aid

Scaling up of development assistance will be effective only if poor countries have adequate capacity to absorb more aid. Capacity constraints to effective absorption of resources can manifest themselves at a number of levels—from national policy and public budget management to local service delivery—and in various ways—including macroeconomic management, institutional capacity, infrastructure, human capital, social, and cultural factors. But not all constraints are equally binding; some can be eased in the near term, while others may take longer.²⁸ Constraints related to the labor market (such as the supply of skilled health and education service providers) and the quality of governance (corruption) might take more time to resolve, while issues such as weak public expenditure management can be overcome more readily.²⁹ Moreover, changes can be mutually reinforcing, with improvements in one area serving as a catalyst in others. All these aspects imply that sequencing is central to capacity building: Interventions across the range of constraints should be prioritized, and public investments aligned with those priorities.

The complex, dynamic nature of capacity building points to the need for country-specific approaches to identifying, analyzing, and addressing capacity constraints. Box 5.3 provides a preliminary assessment of Ethiopia's ability to achieve the MDGs and of labor, macroeconomic, and infrastructure constraints to resource absorption. The modeling framework used helps capture country- and sector-specific constraints (such as skilled labor shortages), cross-effects from investing in related MDGs, and the role of sequencing investment. The simulation results show that it will be possible for Ethiopia to achieve the MDGs if aid (grants) roughly doubles (as a share of GDP) by 2015. They also help illustrate key absorptive capacity constraints, limits to frontloading of disbursements, and the importance of careful sequencing of increases in aid and associated investments.

An Improving Environment for Aid Absorption

The policy and institutional environment in developing countries has steadily improved in recent years, creating a better environment for scaling up aid. In addition to pursuing sound macroeconomic policies and better public sector management, developing countries have strengthened institutions, improved governance, pursued wide-ranging structural reforms, and adopted policies of social inclusion and equity. The overall improvement in policy frameworks and institutional performance has contributed to faster growth in these countries. The average quality of policies and institutions, as measured by the World Bank's Country Policy and Institutional Assessments (CPIAs), has risen over the past five years. Although improvements in some areas (such as institutions and public sector management) have lagged those in others, the overall upward trend is widespread. In tandem, output growth has more than doubled over the average rate of the 1990s, with low-income regions such as South Asia and Sub-Saharan Africa seeing much stronger growth.³⁰

A 2003 Development Committee report assessed the capacity of 18 well-performing low-income countries to effectively use more aid to achieve the MDGs. It found that the five large Asian countries in the sample (Bangladesh, India, Indonesia, Pakistan, Vietnam) could absorb an immediate doubling or more of aid. Some Sub-Saharan countries (such as Ethiopia and Madagascar) could, with substantial policy reforms, also absorb a doubling of aid. Overall, the Sub-Saharan countries in the sample were found to have the capacity to use additional aid productively if they continued and strengthened reforms. Of course, there was considerable variation in absorptive capacity across countries.

The UN Millennium Project recommends identifying well-governed low-income countries as fast-track countries that could receive large increases in assistance.³¹ Existing performance-based criteria—such as being eligible to

BOX 5.3 Addressing absorptive capacity in Ethiopia

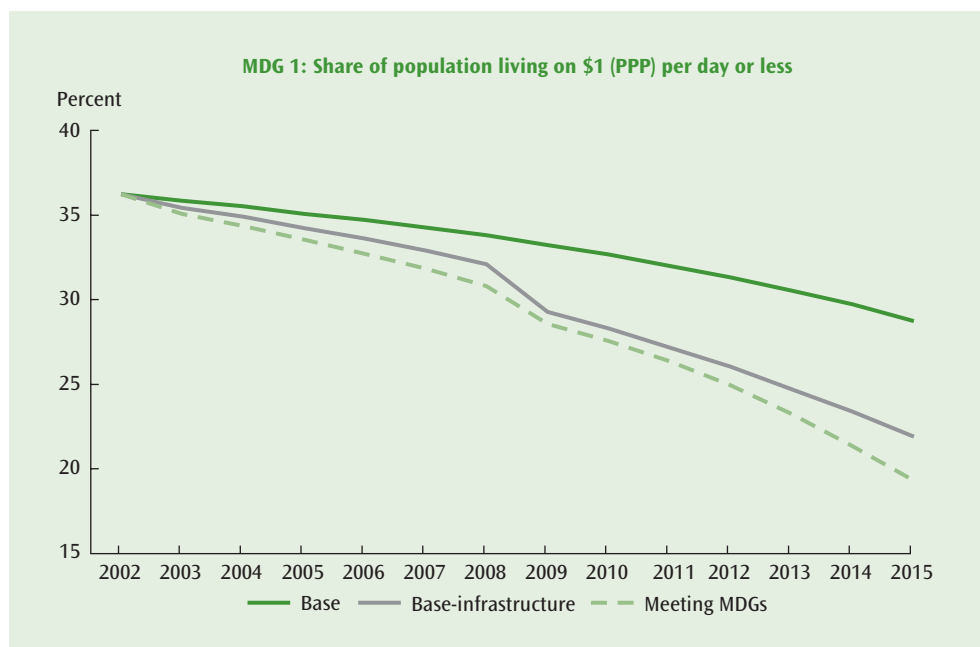
Government policies and the flow of foreign aid required to reach the MDGs have strong economywide effects that, through markets for labor, goods, services, and foreign exchange, feed back on the MDG targets. Measuring and projecting MDG costs and achievements must therefore be based on an economywide approach that complements in-depth sector studies. To examine these macro-micro linkages for Ethiopia—a very poor country for which the MDGs pose enormous challenges—a model has been calibrated to country data to capture select macro and sector-specific constraints. Simulations of progress toward the MDGs are possible that reflect, in particular, labor market, infrastructure, and macroeconomic constraints.

Projections of income poverty levels through 2015 under three scenarios are shown in the figure. The first scenario is a continuation of present trends. Annual GDP growth follows the trend rate over the past decade (3.6 percent), external aid increases marginally (by 1.5 percent a year) above the current level (\$16 per capita), and there is modest investment in physical infrastructure. Under this scenario Ethiopia will fall significantly short on all the MDGs, with poverty falling modestly—from its current 35 percent to 29 percent—and weak progress toward the other goals.

The second scenario adds public investment in basic infrastructure (roads, other transport, energy, irrigation), which is considered critical to growth. Infrastructure investment is frontloaded, growing by 10 percent a year until 2009 and 5 percent a year thereafter, reflecting network effects. Without this investment, Ethiopia cannot reach the first MDG of halving income poverty. The network effects from improved infrastructure enable returns to private sector activities—worker productivity, agricultural yields, and so on—to rise over time. Such investment would require a 15 percent increase in foreign grants relative to the base case. Productivity gains would help boost annual GDP growth to nearly 5 percent after 2009, and poverty reduction would be accelerated, falling to 22 percent by 2015.

Under the third scenario, investments in public services are set at the levels required to achieve the core human development MDG targets—universal primary education completion, two-thirds

Projected income poverty in Ethiopia, 2003–15 (Headcount index)



Note: The projections use the Ethiopia Maquette for MDG Simulation (MAMS) model, parameterized using data from the Ethiopian poverty assessment (World Bank 2005a).

reduction in under-five mortality, three-quarters reduction in maternal mortality, and halving the population share without access to improved water and sanitation services. This scenario requires a gradual but substantial increase in foreign grants, rising to around \$60 per capita, or about 40 percent of GDP, by 2015—roughly twice current aid as a share of GDP.

These scenarios illustrate several key points. It is possible to achieve the MDGs—provided there is adequate external grant financing, and expansion of MDG-related services is accompanied by investment in basic infrastructure to raise growth. Additional aid is essential. Relying on domestic resources to finance such investment would reduce income growth, lower household consumption, and deepen poverty, even though some of the human development MDGs might be achieved. Investment in basic infrastructure is key to supporting economic expansion. Without better growth performance, income poverty goals will not be achieved. In the short run this requires improving physical infrastructure, whereas investing in human development has a longer-term impact on growth.

This framework helps illustrate the important role of absorptive capacity and the lags inherent in expanding capacity. Consider investing to achieve the second MDG—universal primary education completion by 2015. Ethiopia currently has about 75,000 teachers and a student-teacher ratio of 75:1. To meet the goal with an unchanged student-teacher ratio, more than 52,000 additional teachers will need to be trained and deployed by 2015—while as many as 160,000 more teachers would be required for a much-needed reduction in the ratio to 40:1. Recruiting teachers will require increasing the supply of skilled labor—a gradual process with a lagged response—or raising real wages to hire skilled labor away from alternative uses. But raising wages to attract skilled labor raises the costs of public services, draws skilled labor from the private sector, and crowds out private growth.

Constraints to absorptive capacity are also evident in the macroeconomic impact of higher aid flows. Aid permits a larger trade deficit and increases the demand for goods and services. This puts upward pressure on the exchange rate and reduces the competitiveness of both exports and import-competing goods. Over time this may shift the economy away from production for export, make it more dependent on aid, and reduce growth (often called the “Dutch disease”). In the third scenario above, which requires roughly a doubling of aid to GDP by 2015, the real exchange rate appreciates and leads to shrinkage of the export sector. But if public investment made possible by aid increases productivity and removes constraints to growth, this potential drag on output can be offset. This underscores the importance of well-targeted investment and policy measures to offset these costs—particularly improvements in the business environment and trade reforms that improve market access and reduce behind-the-border barriers to export productivity.

The importance of investment sequencing is another lesson from these simulations. Priority must be placed on basic infrastructure investment because of its key role in raising the underlying growth rate and achieving network productivity effects. At the same time, investments must proceed in human services that address binding constraints—such as education to ease skilled labor constraints—and where production lags require earlier attention. Priority should also be given to investments that generate positive externalities and lower costs. Investments in water and sanitation, for example, accelerate improved health outcomes.

There are also implications for the pace of investing in the MDGs. Frontloading infrastructure investment helps accelerate growth through productivity gains. But frontloading expenditures on social and other MDG services runs into absorptive capacity constraints relatively quickly. Real wages rise, the exchange rate appreciates, and growth is compromised. Simulations suggest that for Ethiopia the cost-minimizing share of spending on MDG social services over the first five years is about one-fifth of total expenditures by 2015 (in present value terms) to meet goals related to these services. Note, however, that this calculation ignores the welfare gains of accelerated service delivery due to frontloading.

Finally, improved governance and institutional capacity are crucial to effective delivery of public (and private) services. Both strengthen absorptive capacity and can greatly reduce the costs of improving service delivery over time.

Sources: Bourguignon and others 2004, 2005; Lofgren 2004.

apply for assistance under the U.S. Millennium Challenge Account, having reached the completion point under the HIPC initiative, or participating in the African Peer Review Mechanism (APRM) of the New Partnership for Africa's Development (NEPAD)—could be used to assign fast-track status to countries.

As the relevance of the poverty reduction strategy (PRS) approach continues to grow, the enabling environment for growth and poverty reduction is expected to improve further. In low-income countries Poverty Reduction Strategy Papers (PRSPs) provide the strategic and operational framework for programs and policy reforms to promote growth and reduce poverty. The papers are now also broadly viewed as the key operational vehicle for achieving the MDGs. By the end of February 2005, 47 countries had prepared full PRSPs, and 12 others had prepared interim PRSPs.³² Of these, 33 were Sub-Saharan countries. Solid progress has been achieved in many aspects of the PRS approach, but a key challenge going forward is to deepen implementation on the ground. (See chapter 1 for further discussion of the PRS process and related agenda.)

Countries are paying more attention to improving public expenditure management, which is key for effective aid use. By strengthening such systems, public resources can be aligned better with development priorities, and budget processes can be made more transparent. Many countries have made or are planning significant changes in public expenditure management, and country strategies increasingly include measures to enhance it.³³ Sustained government commitment and strong, well-coordinated donor assistance can boost progress on strengthening public expenditure management capacity.

POVERTY REDUCTION STRATEGIES AND BUDGETS: PROGRESS IN DELIVERING AID IN SUB-SAHARAN AFRICA

Several recent studies have reviewed budgets in highly aid-dependent countries to assess how PRSPs have helped improve aid delivery.

The studies have found that the PRS process has fostered improvements, though there is much room for further progress.³⁴

Uganda saw foreign aid increase by nearly 5 percentage points of GDP between 1997/98 and 2001/02. The increase came in the form of budget support, with 60 percent in grants and the rest in concessional loans. Untied budget support was provided through World Bank Poverty Reduction Support Credits (PRSCs)—a series of annual credits supporting a three-year rolling reform program—and grants from other donors.³⁵ This approach made the overall budget envelope more predictable and helped boost service delivery, especially to poor people.³⁶ Between 1998/99 and 2002/03 the ratio of actual disbursements to amounts initially programmed rose steadily, from less than 40 percent to more than 85 percent. During this period deviations in budget outturns and allocations narrowed, with the discrepancy index falling from nearly 10 percent to 5.5 percent.³⁷ In addition, the share of the budget allocated to the Poverty Action Fund more than doubled, from 17 percent in 1997/98 to 37 percent in 2002/03.

In Tanzania foreign assistance more than doubled during 1999–2003, and donors now finance about 90 percent of the country's development budget.³⁸ Increases in donor financing were associated with increases in priority sector spending.³⁹ With PRS implementation, government spending on priority sectors increased continuously, and by fiscal 2002 such spending exceeded ODA (figure 5.7). But donor funding still exceeds spending on core priority areas, implying that there is scope for sharpening donor focus on these areas. As donors align with national priorities, there is also scope to better integrate their support with the budget.⁴⁰ Aid continues to be highly variable, and though this variability has declined in recent years, it still exceeds that of domestic revenues. Within-year variability of aid flows is substantial as well.

In Burkina Faso, with foreign assistance comprising 40 percent of the budget, donor

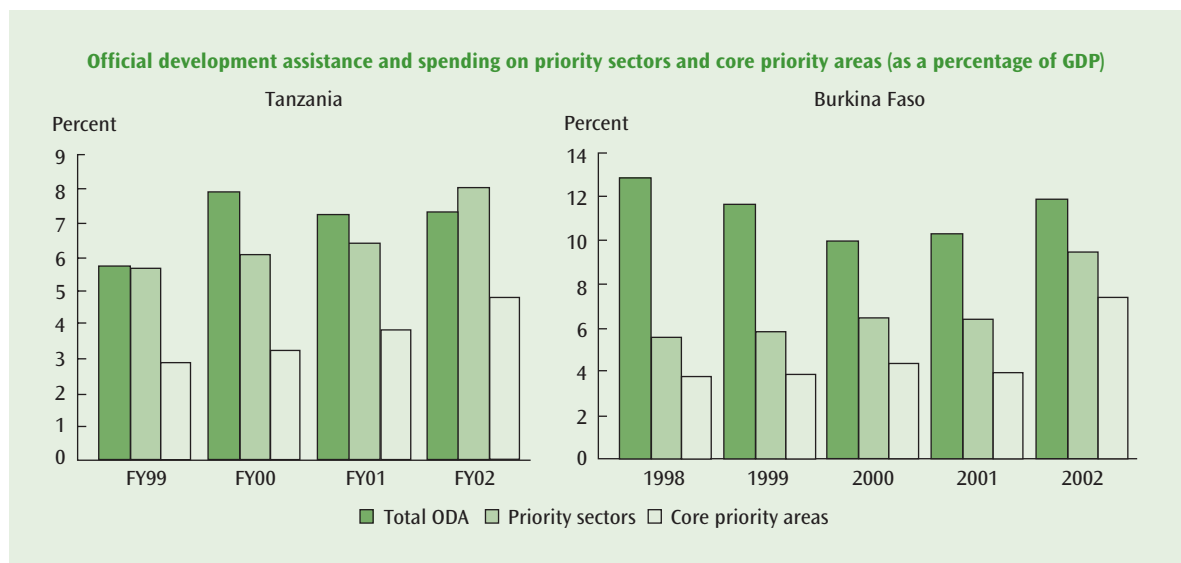
alignment with national priorities is crucial to successful implementation of the PRS. Aid is increasingly aligned with priority sectors, as evidenced by the narrowing gap between ODA and spending on priority sectors and core priority areas (see figure 5.7).⁴¹ Nevertheless, the gap between development assistance and spending on core priority areas remains high, at about 4 percentage points of GDP in 2002—implying that aid is being spent on noncore priority areas. Since the country's PRS was developed, donors have been shifting the composition of aid toward budget support. As a result program loans and grants increased from 2.6 percent of GDP in 1998 to 4.0 percent in 2002, while project loans and grants fell from 8.5 percent of GDP to 6.6 percent. The in-year variability of aid is large, however: During 1996–2000 about 60 percent of aid disbursements were in the last quarter of the year. This bunching of assistance, which is usually not synchronized with the budget cycle, makes it difficult for the country to finance its budget effectively. Receiving funds

at the beginning of the fiscal year would contribute to better public expenditure management. Gaps between PRS projections and actual expenditures can be both large and variable. Gaps in primary education expenditure are in part due to a shortfall in foreign financing—that is, a gap between projected and actual financing. When foreign financing has been late or postponed, this is reflected in a gap between PRS projections and actual expenditures. When foreign financing has been delivered as projected, this gap is relatively small.

COUNTRY STUDIES ON SCALING UP

Development efforts are being scaled up at the national, state, and community levels. The Shanghai conference on scaling up poverty reduction, held in May 2004, showcased a broad range of successful country interventions to reduce poverty and expand access to health, education, water, and other key services (box 5.4). These experiences reinforce some of the factors shown by other evidence as common to successful scaling

FIGURE 5.7 Higher development assistance is increasingly supporting and catalyzing more spending in priority areas



Source: Alonso and Utz 2004; Alonso 2004.

BOX 5.4 Scaling up development efforts

The May 2004 Shanghai conference on scaling up poverty reduction presented a number of country cases of successful efforts to reduce poverty and scale up service delivery. In El Salvador, for example, education reforms have resulted in universal primary enrollment. Years of conflict had weakened the country's education system, and by the end of the 1980s more than a quarter of the population was illiterate, and a fifth of primary school-age children were not in the system. But in the early 1990s the country started reforming the system. The reforms transferred resources and decision making to stakeholders such as schools, communities, and parents. In addition, between 1992 and 2002 public spending on education rose from 1.9 percent of GDP to 3.3 percent. The reforms, which were supported by World Bank sector loans, targeted low-income and rural areas, and helped achieve a gross primary enrollment rate of 112 percent—and more than doubled the secondary enrollment rate, to 56 percent. El Salvador's successful education program has spurred similar innovations in Guatemala and Honduras.

In Indonesia the community-based Kecamatan Development Program has been used to develop infrastructure and alleviate poverty in rural areas. It started small in 1997, operating in 25 villages, and by 2003 it had been scaled up to 28,000 villages. The program provides rural communities with block grants to build small-scale productive infrastructure. The communities receive the transfers at the beginning of the planning cycle, providing certainty of funding. Execution is decentralized, with planning and decision making directly involving local communities. In its first seven years the program reached 35 million people. Other social funds that have involved communities in the planning and decision-making process—such as in Malawi, Yemen, and Zambia—have likewise had national scope and impact.

Source: World Bank 2004d.

up: institutional and policy change; innovation, learning, and adaptation; political leadership and sustained commitment; partnership with all stakeholders (which is key for service delivery); and a supportive external environment.

In sum, emerging country evidence, recent research, a better understanding of how to address absorptive capacity constraints, prospects for continuing favorable trends in policies and institutions, and a stronger focus on governance all show that countries have increased, and continue to increase, their capacity to absorb aid productively. Still, prospects vary by country. Many low-income countries are well positioned to absorb a scaling up of aid. But in some, especially difficult partnership countries, absorptive capacity can be a significant obstacle to scaling up, and innovative ways of channeling aid are needed. In all cases a country-specific

approach anchored in the PRS (or a joint needs assessment, such as the UN–World Bank Post-Conflict Needs Assessment, and results-based framework, such as the Transitional Results Matrix, a multidonor and national stakeholders' coordination and monitoring tool for difficult partnership countries) is required to assess financing needs, identify and address capacity constraints, and appropriately sequence incremental financing and investment.

Making Aid More Effective

The way aid is allocated and delivered is as important as its volume in achieving the MDGs. Broad consensus has emerged that development assistance is particularly effective in poor countries with sound policy and institutional environments.⁴² But even as donors are allocating more aid to better performers,

increasing attention is being focused on the special needs of difficult partnership countries and on seeing how to make aid effective in these economies.

In all countries, donors must provide assistance in ways that are aligned with country-based and -led development priorities as articulated in PRSs or equivalent national development strategies. They should also disburse aid in effective ways—reducing the burden of processes, procedures, and requirements and making aid more predictable. In addition, a stronger focus is needed on the results agenda. This calls for moving from “accounting by inputs” to practical ways of “accounting for outputs.” Equally important to improving aid effectiveness is the need for more coherent donor policies.

Aid Selectivity

Donors are becoming more focused on performance, with aid allocations increasingly determined by both policy performance and poverty. The policy selectivity index, which measures the elasticity of aid with respect to the quality of recipients’ policies and institutions (based on the World Bank’s CPIAs), shows a generally improving trend in 1999–2003 (table 5.1).⁴³ This trend has been fueled by the sharpening policy focus of multilateral assistance: The relationship between aid and policy performance is much stronger for multilateral than for bilateral aid. But bilateral aid does exhibit a significantly positive relationship with the quality of recipients’ policies and institutions—for more than 80 percent of bilateral donors this relationship is positive, and for more than half it is statistically significant. Still, some of the largest bilateral donors are not very selective. Donors’ poverty focus has strengthened as well, as reflected in the rise in the poverty elasticity index (elasticity of aid with respect to recipients’ per capita income). Thus more aid is being allocated to poorer countries by both bilateral and multilateral donors.

Since the various components of aid are far from homogenous, it is not surprising to

see substantial variation in the policy and poverty sensitivity of the different types of aid. The results for disaggregated aid indicate that flexible ODA is more sensitive to policy performance than technical cooperation.⁴⁴ On average, a 100 percent increase in the quality of recipients’ policies and institutions is associated with a more than 250 percent increase in flexible ODA. Technical cooperation, by contrast, is not sensitive to the quality of policies and institutions. This category of aid is also the least selective with respect to poverty, reflecting the fact that technical cooperation is provided to a broad range of countries—including special need and conflict countries with extremely weak institutional capacity, and middle-income countries with institutional capacity gaps in narrowly defined areas. Overall, the results suggest that the scope for improving the allocation of aid by altering its composition is potentially large.

Donor focus on performance is stronger in low-income countries. Thus some donors that are not very selective in overall aid allocations nevertheless tend to favor better performers

TABLE 5.1 Selectivity in aid allocation: Donors’ policy and poverty focus is improving, but bilateral donors could do more

Official development assistance net of emergency aid				
Flow	Policy selectivity 1999	Policy selectivity 2003	Poverty selectivity 1999	Poverty selectivity 2003
Total aid	1.57*	1.77*	−0.34*	−0.55*
Bilateral aid	1.15*	1.04*	−0.27*	−0.47*
Multilateral aid	2.09*	2.71*	−0.68*	−0.87*
Five largest donors				
United States	1.37	1.43	−0.77*	−0.88*
Japan	3.72*	1.74*	−0.23	0.01
France	0.65	1.27	−0.17	−0.32
Germany	1.99*	3.36*	−0.24*	−0.52*
United Kingdom	2.82*	3.89*	−0.47*	−1.21*

Source: Levin 2005.

* Significant at the 10 percent level or higher.

Note: Policy selectivity shows the policy selectivity index, which measures the elasticity of aid with respect to the quality of recipients’ policies and institutions. Poverty selectivity shows the poverty elasticity index, which measures the elasticity of aid with respect to recipients’ per capita income.

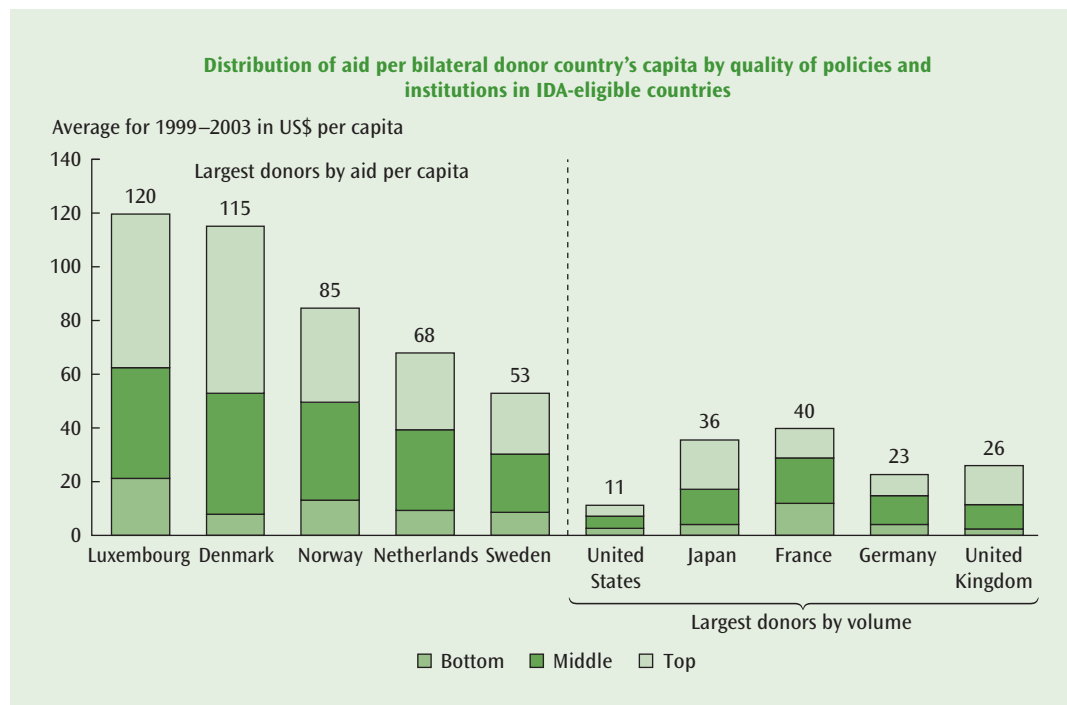
among poor countries. The best-performing third of recipients (as measured by the Bank's CPIAs) receive an average of 40 percent of aid allocations—while the worst-performing third receive 17 percent (figure 5.8). There is wide variation in donor effort directed at low-income (IDA-eligible) countries. During 1999–2003 countries that were consistently the top providers of assistance per donor country citizen to low-income countries were Denmark (with an annual average of \$62 out of a total of \$115 per Danish citizen directed to the top third of policy performers in low-income countries), Luxembourg (\$57 out of \$120), Norway (\$35 out of \$85), Netherlands (\$29 out of \$68), and Sweden (\$23 out of \$53). Comparable amounts for some of the largest donors are \$4 out of \$11 for the United States and \$11 out of \$40 for France. The more generous donors in terms of per capita aid effort are also generally more selective.

Aid Effectiveness in Difficult Partnership Countries

As bilateral donors move toward more policy and poverty selectivity in aid allocation, there is concern that difficult partnership countries may be underfunded.⁴⁵ Empirical evidence shows that these countries receive about 40 percent less aid than predicted by their policy and institutional ratings (figure 5.9).⁴⁶ There is wide variation, with the so-called “aid orphans” receiving much less aid and the “aid darlings” receiving much more than can be explained by policy and poverty criteria. While not all difficult partnership countries should receive more aid, the results suggest that an increase in overall aid to the group would not compromise the performance basis of aid.⁴⁷

Recent studies find that postconflict countries can absorb more aid than other low-income countries with similar levels of

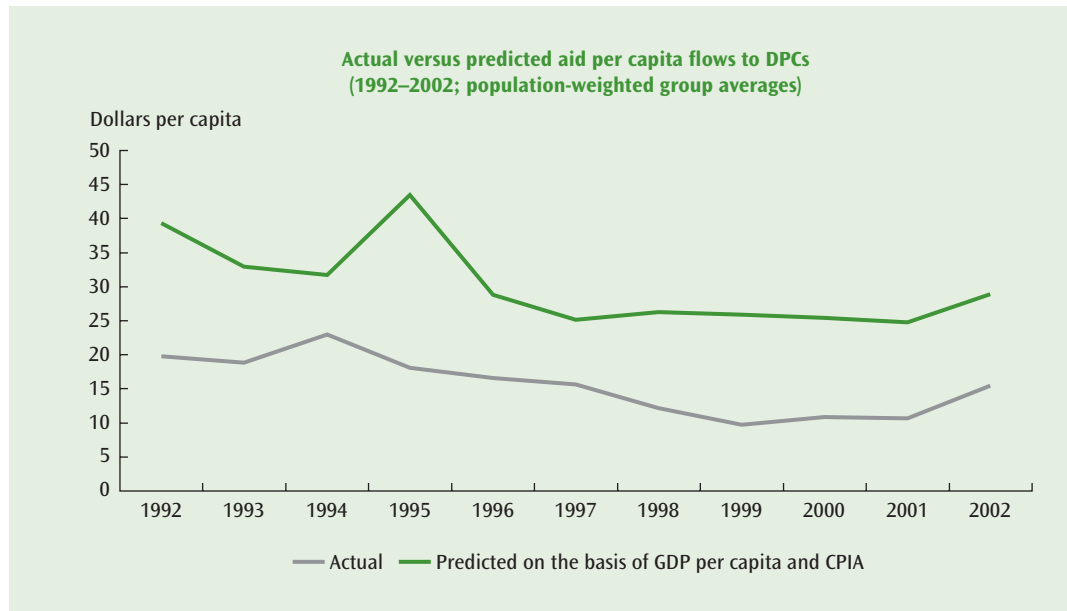
FIGURE 5.8 In low-income countries donors allocate more aid to better performers; more generous donors also tend to be more selective



Source: Based on Levin 2005.

Note: IDA-eligible countries are split into three groups—bottom, middle, and top—using the 33.3 and 66.7 percentiles of quality of policies and institutions as measured by the World Bank's Country Policy and Institutional Assessments (CPIAs).

FIGURE 5.9 Difficult partnership countries receive less aid than predicted by their policy/institutional quality and poverty levels



Source: Levin and Dollar 2005.

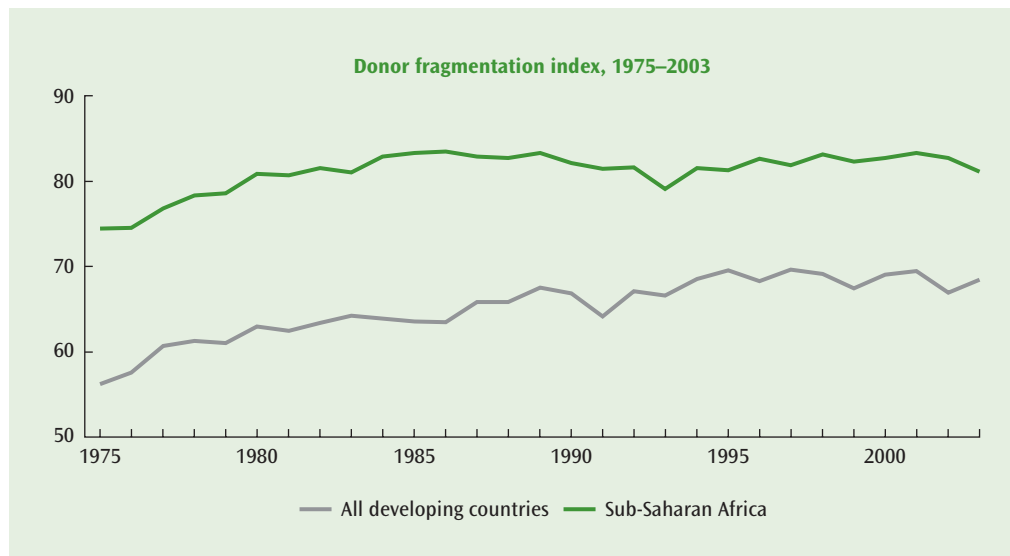
poverty and institutions. Aid allocation patterns in postconflict periods show an increase in the first few years after a conflict ends, followed by a dropoff. One study finds that relative to conflict levels, per capita aid is generally \$2 higher in the second year after conflict, then rises and peaks at around \$9 per capita higher in the fourth year after conflict.⁴⁸ Another finds that the increase is highest in the first two postconflict years, then falls off.⁴⁹ But postconflict countries can effectively absorb higher levels of aid in later periods when their absorptive capacity has increased, so higher aid sustained over longer periods is more desirable for ensuring turnarounds in these countries.⁵⁰ Thus donors need to provide assistance over a longer period—an example is Sierra Leone’s 10-year development plan—to rebuild weak capacity, restart growth, and reduce poverty. The Senior Level Forum on Development Effectiveness in Fragile States—organized jointly by DAC and bilateral and multilateral donors and held in London in January 2005—addressed the issue of how to improve effectiveness of aid in fragile states and the principles of good donor

practice in these countries.⁵¹

Because these countries have weak capacity and risky environments, delivering effective aid is a considerable challenge.⁵² Aid should be focused on building capacity and providing key services through innovative mechanisms. Some successful approaches are emerging, including those that use local institutions to deliver services and those that work with non-state actors in ways designed for eventual transfer to state delivery. (See chapter 3 for more on service delivery in countries under stress.) The appropriate aid modality is likely to vary by country situation. But to be effective, aid needs to be better coordinated to minimize the problem of aid darlings and orphans, as well as better sequenced and sustained.

Aid Fragmentation

Donor fragmentation remains high in developing countries. A donor fragmentation index, constructed from shares of individual bilateral donors in annual bilateral aid flows, shows that the degree of fragmentation in 2003 was largely unchanged at 68; in 2002 the index was

FIGURE 5.10 Aid fragmentation is high, especially in Sub-Saharan Africa

Sources: OECD DAC database; World Bank staff estimates.

Note: The indexes graphed are averages over groups of aid recipient countries. Donor fragmentation goes from 0-100; higher values imply more fragmentation.

67 (figure 5.10). High fragmentation can have negative implications for aid quality for several reasons: high transaction costs for recipients because more time is taken meeting donor requirements; too many small projects, with consequent limited opportunities to reap scale economies; and smaller or narrower donor stakes in overall country outcomes.⁵³ A large number of donors also compounds the challenge of donor coordination. A number of members of OECD's Development Assistance Committee (DAC) are considering measures to limit the number of countries on which they focus. Although the recent High Level Forum on Aid Effectiveness (held in Paris in March 2005) did not include fragmentation among the 12 indicators it adopted to monitor reforms of aid delivery and management, donors committed to delegating authority to lead donors, where appropriate, to reduce transaction costs.

The problem is especially severe in Sub-Saharan Africa, where the donor fragmentation index for 2003 is 81. The high degree of donor fragmentation is especially surprising given that aid tends to be concentrated in relatively few countries: 60 percent of bilateral aid to the region goes to 10 countries. But although donors have their

favorite countries, they like to be present in many countries in the region. On average, a recipient country in Sub-Saharan Africa received aid from 25 donors a year over the past two decades.⁵⁴ The number varies, ranging from 16 for Gabon to 37 for Ethiopia in 2003.

Untying Aid

Untying of aid significantly increases its effectiveness, yet large amounts of bilateral ODA continue to be tied. The DAC recommends untying all aid, excluding technical cooperation and food aid, to the least developed countries (LDCs).⁵⁵ Almost all DAC countries have largely implemented these provisions, but four donors, including the largest (the United States), do not report on the tying status of their bilateral ODA. Technical cooperation, which accounts for more than a third of bilateral ODA and is largely spent on source-country expertise, is essentially a form of tied aid. Although substantially smaller, food aid (excluding humanitarian assistance) is mostly tied as well.

Tying aid is costly for recipients. A recent OECD study finds that untied food aid can reach up to 50 percent more beneficiaries than

does tied aid.⁵⁶ Other studies have also found that untying (project) aid yields sizable savings.⁵⁷ More progress on untying categories of aid that are currently tied and broadening coverage to other developing countries would improve the effectiveness of aid. DAC members are considering several options to expand the scope of recommendations on untying aid. At the recent Paris High Level Forum on Aid Effectiveness, DAC donors agreed to continue to make progress on untying aid and to monitor this progress through an indicator that measures the share of bilateral aid that is untied.⁵⁸

Reliability of Aid Flows

Given the large size of official flows relative to the incomes of many countries, variations in these flows can cause problems. Volatile, unreliable aid flows can undermine budget management in recipient countries and efforts to develop medium-term expenditure frameworks. In poor countries aid shortfalls are typically offset by cutbacks in spending, and sometimes by tax increases.⁵⁹ Improving the reliability of aid is important to increasing its effectiveness. It is also important for effective scaling up of assistance: Countries that commit to sustained reforms should be assured of timely, more predictable, and longer-term aid commitments. The predictability of aid will be monitored using the indicators agreed under the Paris Declaration, to minimize gaps between aid commitments (under agreed schedules in annual or multiyear frameworks) and actual disbursements.

Although donors are beginning to pay more attention to aid volatility and predictability, cross-country data reveal no significant improvement in these areas. Cross-country data for 1995–8 and 2000–3 indicate that aid continues to be more volatile than fiscal revenue.⁶⁰ Moreover, the volatility of aid relative to revenue appears to have edged up: The measure of the volatility of aid relative to revenue in 2000–3 is nearly twice the median value of 1995–8. Aid to poor countries is also more variable than these countries' GDP.⁶¹ In addition, aid commitments remain poor predictors of disbursements, particularly for the poorest

countries—such countries receive only about half of promised aid. The data also show that aid does not counter large income shocks. Among countries experiencing adverse macroeconomic shocks equivalent to 5 percent or more of GDP, only a fifth saw higher aid.

Progress on Harmonization, Alignment, and Results

Aid is more effective when it is aligned with recipients' priorities, when it reduces transaction costs through harmonized processes and procedures and donor coordination, and when it is predictable. Related to such efforts is the need for a clearer focus on managing for development results. An overarching principle of the harmonization and alignment agenda is that donors should support country-owned strategies for growth and poverty reduction—in the form of poverty reduction strategies or equivalent national development plans—and base their programming on the needs and priorities identified in these strategies. In addition, development assistance should be provided in ways that build on partners' sustainable capacity to develop policies, implement them, and account for these activities to their people and legislatures.

IMPLEMENTING ALIGNMENT AND HARMONIZATION

The 2003 Rome High Level Forum provided an impetus for advancing alignment and harmonization, and this global agenda was the focus of the recent Paris High Level Forum—where ministers and senior officials from more than 90 developed and developing countries and 25 heads of multilateral and bilateral donor agencies reaffirmed their commitment to the Rome Declaration. Through the Paris Declaration, donors and partners agreed to mutual accountability in carrying out the partnership commitments made by both sides. The international development community has agreed to measure progress on aid effectiveness using 12 indicators (table 5.2). The indicators cover dimensions of ownership, alignment, harmonization, managing for results, and mutual accountability. To track and encourage progress at the global level

TABLE 5.2 Indicators of progress (on ownership, harmonization, alignment, and results)
To be measured nationally and monitored internationally

OWNERSHIP		TARGET FOR 2010 ^a
1	<i>Partners have operational development strategies</i> —number of partner countries with national development strategies (including PRSs) that have clear strategic priorities linked to medium-term expenditure frameworks and reflected in annual budgets	At least 75% of partner countries
ALIGNMENT		
2	<i>Reliable country systems</i> —number of partner countries with procurement and public financial management systems that adhere to broadly accepted good practices or have a reform program in place to achieve these	Target to be set by September 2005
3	<i>Aid flows aligned with national priorities</i> —percent of aid flows to the government sector that is reported in partner countries' national budgets	85% of aid hours reported on budgets
4	<i>Strengthen capacity by coordinated support</i> —percent of donor capacity-development support provided through coordinated programs consistent with partner countries' national development strategies	Target to be set by September 2005
5	<i>Use of country systems</i> —percent of donors and of aid flows that use partner country procurement and/or public financial management systems in partner countries, which adhere to broadly accepted good practices or have a reform program in place	Target to be set by September 2005
6	<i>Strengthen capacity by avoiding parallel implementation structures</i> —number of parallel project implementation units per country	Target to be set by September 2005
7	<i>Aid is more predictable</i> —percent of aid disbursements released according to agreed schedules in annual or multiyear frameworks	At least 75% of such aid released on schedule
8	<i>Aid is untied</i> —percent of bilateral aid that is untied.	Continued progress
HARMONIZATION		
9	<i>Use of common arrangements or procedures</i> —percent of aid provided as program-based approaches ^b	At least 25%
10	<i>Encourage shared analysis</i> —percent of field missions and/or country analytic work, including diagnostic reviews, conducted jointly	Target to be set by September 2005
MANAGING FOR RESULTS		
11	<i>Results-oriented frameworks</i> —number of countries with transparent, monitorable performance assessment frameworks to assess progress against national development strategies and sector programs	75% of partner countries
MUTUAL ACCOUNTABILITY		
12	<i>Mutual accountability</i> —number of partner countries that undertake mutual assessments of progress in implementing agreed commitments on aid effectiveness, including those in this (Paris) Declaration	Target to be set by September 2005

Source: OECD 2005e.

a. Existing targets will be confirmed or amended by September 2005.

b. See OECD 2005e, appendix A.

and among countries and agencies, participants at the Paris forum also agreed to set targets for 2010 for 11 of the 12 indicators. Five preliminary targets were agreed during the forum, and these and the others will be finalized and adopted before the UN General Assembly summit in September 2005.

Evidence from an OECD DAC Working Party on Aid Effectiveness and Donor Practices

(WP-EFF) survey,⁶² Strategic Partnership for Africa (SPA) surveys, and the United Nations Economic Commission for Africa (UNECA)–DAC Mutual Review of Development Effectiveness in the Context of the New Partnership for Africa's Development (NEPAD) show that partner countries and donors are working together and taking actions to improve coordination and aid effectiveness (box 5.5). The

BOX 5.5 Alignment and harmonization: country examples show a wide variety of approaches

Cambodia. Establishing country ownership takes time, patience, perseverance, and resources. To address problems of poor aid management, Cambodia's government and donors have launched various initiatives since a new coalition government was formed in the late 1990s. The multidonor, three-year Technical Cooperation Action Plan was approved in 2001 to help the government strengthen its capacity to formulate and implement sound macroeconomic policies and manage public finances. In the past few years Cambodia has started to connect to the global debate and is now a signatory to the Rome and Paris declarations on harmonization. A number of recent developments have significantly improved prospects for moving toward more productive use of resources. For example, the government has committed to merge three donor-funded strategies—the Second-Socio-Economic Development Plan 2001–5 (supported by the Asian Development Bank), Cambodia's Millennium Development Goals (supported by the United Nations Development Programme), and the National Poverty Reduction Strategy (supported by the World Bank and IMF)—into one poverty-focused national development plan for 2006–10. Donors have responded with common country strategy development processes, joint analytic work, joint support for public financial management reforms, sectorwide approaches (SWAs), and other types of collaboration. In November 2004, together with local donors, the government developed a National Action Plan for Harmonization and Alignment to guide implementation of its commitment to the Rome and Paris declarations on ownership, leadership, capacity building, harmonization, and alignment. Government-donor collaboration on public financial management reforms was further strengthened under a SWAp launched in late 2004.

Ethiopia. In many countries where national systems are inadequate for donors to rely on, the donor community has bolstered collective action on capacity development efforts to help strengthen the systems. Recognizing that public sector capacity building efforts were largely supported by fragmented donor projects and ad hoc financing, the government launched a consolidated five-year program to rapidly scale up capacity building and institutional transformation efforts in six crucial areas: a regional decentralization program that rapidly transferred delivery responsibilities—with substantial fiscal and administrative authority—to rural jurisdictions; municipal reforms designed to restructure and empower urban centers; reformulated civil service reforms increasingly focused on strengthening the public sector fiduciary framework and service delivery results on the ground; initiatives to enhance connectivity and develop e-government applications and school Internet projects, efforts to reform the justice system (including the courts, lawmaking and law enforcement institutions, and the legislative process); and ongoing tax reforms that strengthen tax policy and administration at the federal and regional levels. In 2003 the scaling up process resulted in a SWAp: Seven donors combined their financial support under the program and aligned their procedures with the government's planning, budgeting, and disbursement procedures.

Honduras. The Honduran PRS provides a framework for donors to align around country priorities. An executive office has been established to unblock project implementation bottlenecks and accelerate the achievement of results, and the government has begun negotiating with donors to restructure some operations for greater program coherence. Donors have cooperated by making institutional changes such as decentralized funding approvals, accepting lead donor roles in some areas, carrying out joint analytic work, and coordinating fiduciary requirements.

Middle-income countries. Many middle-income countries have not elaborated formal harmonization and alignment efforts, but have simply pursued relevant aspects of the agenda. In Brazil, India, Mexico, and Morocco donor assistance often involves SWAs and increasingly relies on country systems for financial management, disbursements, and procurement. Brazil's Bolsa Familia SWAp, for example, integrates several pro-poor federal programs into one comprehensive program covering health, education, and nutrition, with program implementation streamlined into a single administrative and management mechanism. Poland's Road Maintenance and Rehabilitation Project is fully aligned with the government's program and budget cycles, and implementation relies heavily on country systems for financial management, accounting, and environmental safeguards.

Source: World Bank staff.

BOX 5.6 Mozambique's performance assessment framework— for donors

All African multidonor budget support arrangements define a framework for periodically assessing country performance. In an innovative twist, Mozambique's government and donors have agreed to establish a performance assessment framework for the donor community as well. The objective is to monitor donor behavior on commitments, expose noncompliance and weaknesses to peer pressure, and strengthen donor accountability to government. Key features of this arrangement include:

- Donors will identify the indicators to be assessed, which subsequently will be discussed with and vetted by the government.
- Donor performance will be assessed by an independent team and subject to periodic discussion by the government and donor peers.
- The donor performance assessment framework will be linked to an action plan and timeframe for its implementation.
- Annual donor performance reports will be released publicly.
- The framework will be continuously adapted based on collective and individual donor assessments.

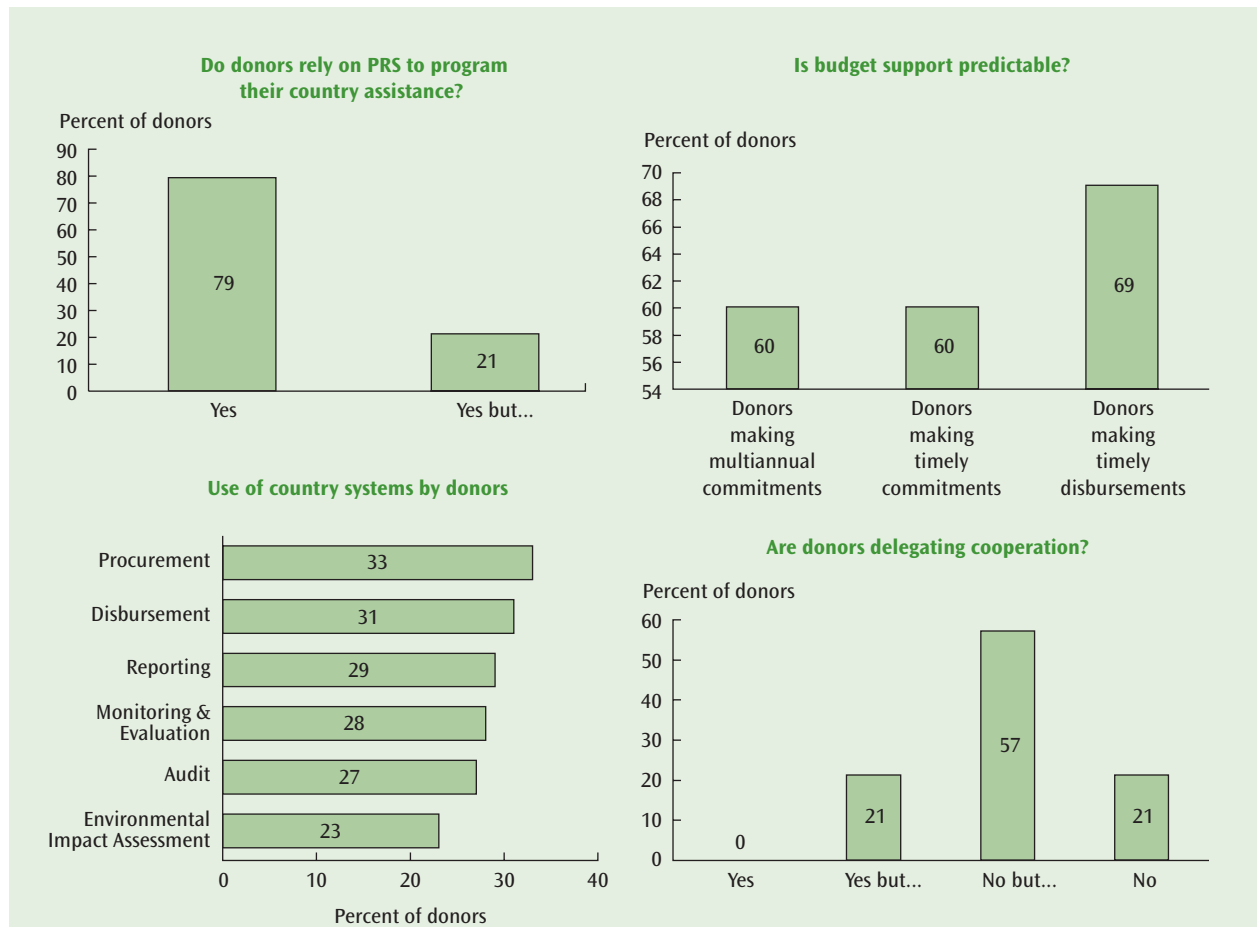
Source: Gerster and Harding 2004.

SPA surveys and the UNECA-DAC report find that while progress is being made in African countries, it has been uneven and concentrated in countries that have worked longest and hardest to take ownership of the aid process (box 5.6). By the end of 2004 more than 60 partner countries (worldwide) and 40 bilateral and multilateral agencies were engaged in harmonization and alignment activities. The challenge remains to ensure that the broad range of activities taking place, and the energy and creativity driving them, help increase aid effectiveness.

Aid management and alignment. The WP-EFF has begun to quantify progress toward the harmonization and alignment commitments adopted in the Rome Declaration in 2003. After the Rome meeting a set of country-level indicators were developed, and the WP-EFF surveyed harmonization and alignment in 14 partner countries self-identified at the Rome forum as being interested in pursuing harmonization efforts.⁶³ The working party's survey found that donors are internalizing the principle of aligning their program-

ming to the needs and priorities identified in PRSs. More than four-fifths of the donors consulted indicated they rely on PRSs to program their country assistance, and only a fifth expressed reservations (figure 5.11).⁶⁴ But the WP-EFF and SPA surveys found only a small number of collaborative approaches to harmonizing donor assistance around agreed country priorities, and little evidence that, overall, donors have adapted their programs in support of national growth or poverty strategy priorities. Furthermore, in a number of countries growth and poverty strategies are still broad, and while donors may be aligned on broad categories—that is, priority sectors—this may not imply alignment on core priority areas.

Aid flexibility and predictability. The WP-EFF survey found that for countries that receive budget support, 60 percent of donors provide multiyear commitments and timely commitments, and 69 percent disburse budget support on schedule (see figure 5.11). Effective public expenditure management is an important prerequisite for efficient use of budget support, and

FIGURE 5.11 Progress on alignment, harmonization, and predictability of aid needs to be accelerated

Source: OECD 2004b.

countries are making progress on strengthening these systems and public financial management (see above). Still, further progress on aid flexibility is hampered by insufficient clarity about country policy and investment priorities and the absence of a robust medium-term framework that links these priorities to country budget and spending decisions and timetables. Also, there is considerable variation in donor behavior across countries. While 93 percent of donors make multiyear commitments on budget support in Tanzania and 79 percent in Mozambique, only 40 percent do so in Bangladesh—and a mere 20 percent in Zambia.

The UNECA-DAC report finds that despite an increase in budget and sector support among good performers, there has been little overall change in the aid landscape in Africa.⁶⁵ Projects are still the dominant mode of aid delivery, particularly for bilateral assistance, and are often administered outside partner oversight and control. In addition, capacity development efforts continue to fall outside mainstream aid coordination and effectiveness efforts: They are still invariably piecemeal, atomistic, and supply driven. But coordinated multidonor budget support efforts are emerging in several countries, particularly where aid

relationships are characterized by mutual trust and accountability.

Limited use of country systems. Donors continue to make limited use of country systems. One of the main goals of the Rome agenda was to provide development assistance in ways that build partners' sustainable capacity to develop policies, implement them, and account for these activities to their people and legislatures. This means increased reliance on partners' systems and procedures to manage aid. Yet few of the donors active in the 14 countries surveyed by the DAC Working Party reported using partner systems (for financial reporting, disbursement, procurement, audit, monitoring, and evaluation), and there are significant disparities between them in this area. Of course, country systems must meet certain criteria for donors to rely on them.

On average, the donors reported that only 29 percent of their projects are managed using partner systems and procedures. Results ranged from 23 percent of donors who said they rely on country systems for environmental impact assessments to 33 percent who use country procurement systems. Additional technical work has been done since Rome and Marrakech to develop criteria for assessing and strengthening country systems and for harmonizing donor requirements around them. In several cases these criteria are guiding efforts among groups of donors to simplify and harmonize fiduciary, monitoring, and reporting arrangements.

Sectorwide approaches. Sectorwide approaches (SWAs) are used to provide comprehensive, coordinated support for country-led sector programs. In 2003–4 borrowers from multilateral institutions showed increased interest in SWAs as a means for aligning around sector priorities. A growing number of SWAs use existing country frameworks to channel and account for funds, becoming an integral part of the harmonization and alignment agenda. In Brazil (health), India (education), Mexico (rural infrastructure), and Poland (roads), SWAs use country systems for procurement and financial management.

The SPA survey shows that sector support operations are an important aid delivery mechanism for promoting and consolidating harmonization and alignment. The survey concludes that strong elements of harmonization in sector programs included joint consultations with stakeholders, analytic work, partner reviews and government reporting, and monitoring and evaluation. Harmonization was weaker on procurement arrangements, disbursement mechanisms, financial management, technical assistance, and capacity building.

Delegated cooperation. Donors are also pursuing delegated cooperation in some areas. The Rome Declaration encourages donors to intensify their efforts to work through delegated cooperation at the country level as a means of reducing transaction costs by making greater use of the comparative advantages of individual donors. For instance, in a delegated cooperation agreement being prepared for Ethiopia, Sweden will delegate its role in the health program to Norway, while Norway will delegate its role in the education program to Sweden. The level and form of delegation vary considerably, and the DAC Working Party survey found relatively few examples of delegated cooperation. Only 21 percent of donors across 14 countries reported that they were delegating cooperation, and less than 8 percent of donor missions were carried out jointly.⁶⁶

How recipients view donor efforts. The SPA Budget Support survey asked African governments to describe their satisfaction with donor behaviors in a number of areas. The results indicate that donors made some progress between 2002 and 2003 (table 5.3). There seems to be a higher degree of coordination (if not harmonization). Moreover, satisfaction rose in countries with more experience and higher budget support (Mozambique, Tanzania, Uganda) and fell in countries with less experience and lower budget support (Benin, Niger, Rwanda).

Partner countries also viewed donors positively in areas such as providing timely information on planned disbursements (with a

score of 3.8 out of 5.0), aligning disbursements with national budget cycles (3.6), disbursing at the intended time (3.5), and using government reports with minimal demands for other information (3.5).

MANAGING FOR DEVELOPMENT RESULTS

The development community has moved from conceptualizing to implementing the global results agenda. Some early progress in managing for development results is evident at the country and agency levels and across aid agencies. Partner countries are beginning to focus on results and are integrating results in their development strategies. For example, strong strategies for education and health in Ethiopia have helped set a well-prioritized and -costed PRS program.

Budget processes and public expenditure management efforts have the strongest results orientations. In all countries there has been a move to apply the principles of managing for results in line ministries, programs, or cross-cutting themes. Stronger links are observed in Brazil, the Philippines, South Africa, Thailand, Vietnam, and Uganda. A number of countries have also developed strategies to improve their monitoring and evaluation systems. Recognizing the importance of quality statistical systems for monitoring and evaluation, a few countries—Burkina Faso, Ukraine—have started programs for statistical capacity development, and strategic plans for statistical systems are being finalized in other countries—Albania, China, India, Kenya, Nigeria, Yemen.

Aid agencies are strengthening the focus on results in their country programs, financial instruments, incentives, and reporting systems. Many agencies are deriving country programming from PRSs and linking country support to a partner's medium-term expenditure framework. Emerging practices are being shared and analyzed in the DAC Joint Venture on Managing for Development Results. All aid agencies have strengthened monitoring and evaluations to better ascertain the quality and impact of their operations. They are also working to enhance staff ownership

TABLE 5.3 African governments are viewing donor behavior more favorably (scale of 1 to 5; 5 is highest)

Area	2002–3	2003–4
Conditionality coordinated	3.0	3.4
Joint missions or reviews	3.2	3.4
Reporting requirements minimized and coordinated	3.2	3.1
Coordinated support on public finance reforms	3.1	3.3
Coordinated support to strengthen statistical systems	2.7	3.1
Conditionalities seen as useful	3.1	3.6
Number of conditions minimized		2.1

Source: SPA Budget Support Working Group 2004.

of the results agenda through guidance, training, and information technology systems. Both bilateral and multilateral agencies have strengthened their development effectiveness work and corporate reporting.

At the global level, aid agencies are working more systematically in identifying actions that produce results, scaling up support for that work, and ensuring the availability of appropriate data. Work is under way on presenting existing experiences in a *Sourcebook on Emerging Good Practice in Managing for Development Results*. Aid agencies are seeking to harmonize results reporting requirements around national monitoring and evaluation systems that help countries manage for results. Progress is expected in four African pilot countries in 2005. Aid agencies are also beginning work on jointly assessing monitoring and evaluation settings in partner countries and aligning capacity building support with national strategies for monitoring and evaluation, which will be pursued by supporting communities of practice in managing for development results.

CHALLENGES AHEAD

Progress on harmonization and alignment has been mixed, and that on managing for results is just beginning. The pace of progress needs to be accelerated. It will not be easy, because achieving harmonization, alignment, and managing for results requires intensive work among

participants—donors and partner countries—to remove obstacles. Continued commitment at the highest levels to the harmonization, alignment, and results agenda will be needed for its successful implementation. Participants at the Paris High Level Forum acknowledged that enhancing the aid effectiveness is feasible and necessary across all aid modalities, and they committed to concrete actions to address challenges that impede progress.

In partner countries weaknesses remain in growth and poverty reduction strategies as well as in institutional capacities to manage these strategies for results. Progress in exercising country ownership and leadership of the development process can be broadened, deepened, and facilitated by strengthening the national development strategy process—for example, by integrating PRSs with budget processes and widening the participation of key stakeholders in developing the strategies. To ensure mutual accountability, donors should provide comprehensive, timely, transparent information on aid flows, and governments should commit to public financial reporting that includes clear, monitorable, outcome-based targets.

Among donor agencies, fragmented and uncoordinated assistance at the country level needs to be minimized and programs aligned with country priorities, processes, and systems. Also, donors need to help strengthen countries' capacities to implement national development strategies. Donors should streamline conditionality to focus on the priorities that governments set out in their development strategies. To increase donor complementarity, agencies should seek ways of improving cross-country balance and avoid major gaps and overlaps, applying comparative advantage principles between and among bilateral and multilateral agencies. The agreed aim is for donors to commit to use country systems, as soon as they jointly assess them as being robust enough, in at least four key areas: public financial management; procurement; monitoring and evaluation; and environmental and social safeguards. But in determining the most effective modalities of aid delivery, donors must ultimately be

guided by the development strategies and priorities established by partner countries.

In aid agencies, managing information and decision gaps between headquarters and field staff is critical to facilitate progress on harmonization. Agencies need to assess their accountability regimes and mandates to see how increased delegation of authority to the field can promote more effective aid at the country level. Creating incentives for harmonizing and aligning—at the political, institutional, and individual levels—is another critical variable on which more thought and action are needed.

Debt Relief

Most debt relief to low-income countries has occurred under the aegis of the HIPC initiative, including the enhanced version of the initiative introduced in 1999. But donor assistance for debt relief involves more than one-time reductions in developing countries' debt levels—it also requires ensuring that countries have the capacity and ability to ensure that debt remains at sustainable levels. In addition, recent proposals have suggested that donors introduce new approaches and programs to ease debt.

Progress on the HIPC Initiative

For heavily indebted poor countries, debt relief is crucial to create the fiscal space for much-needed increases in spending to promote growth and reduce poverty. Overall, substantial progress has been made in implementing the enhanced HIPC initiative. By March 2005, 27 HIPCs—more than two-thirds of the 38 countries that potentially qualify for assistance under the initiative, and accounting for about two-thirds of total expected debt relief in net present value terms—had reached their decision points and were receiving relief. Of these, 15 had also reached their completion points—when creditors provide the full amount of debt relief committed at the decision points on an irrevocable basis.

Progress on reaching completion points increased in 2004, and three more countries

are expected to reach their completion points by mid-2005. For many of the 12 countries in the interim stage between decision and completion points, maintaining macroeconomic stability remains a challenge. Although a number of countries are on track with respect to their macroeconomic programs, others that have experienced difficulties in program implementation are pursuing the policy measures needed to bring their economic programs back on track.⁶⁷ Most of the countries in the interim stage have finalized their PRSs and are making good progress in implementing them.

Of the 11 countries that have not reached their decision points, 2 are making significant progress and are expected to reach their decision points in 2005. For the others, significant challenges remain: These countries have been affected by domestic conflicts and have protracted arrears to various creditors, which has complicated the design and implementation of reform programs.

The sunset clause of the HIPC initiative has been extended by two years to the end of 2006, with its application ring-fenced to poor countries with unsustainable external debt based on end-2004 data. All IDA-only and Poverty Reduction and Growth Facility (PRGF)-eligible countries that have not benefited from HIPC debt relief and whose external indebtedness (based on end-2004 data) exceeds the enhanced initiative's thresholds after the assumed full application of traditional debt relief are potentially eligible for the initiative. World Bank and IMF staff are preparing a preliminary list of countries that meet this criterion for consideration by the institutions' boards in August 2005. As now, countries would receive debt relief based on the level of debt at the time of reaching the decision point.

HIPC relief is projected to substantially lower debt stocks and debt service ratios for most HIPCs that have reached their decision points. Net present values of debt stocks in the 27 HIPCs that reached their decision points by mid-March 2005 are projected to decline by about two-thirds once they reach

their completion points. HIPCs in the interim period have benefited from debt relief from the Paris Club as well as from several multilateral creditors. Ratios of debt service to exports and to fiscal revenues for the 27 countries that have reached their decision or completion points are estimated to have fallen from an average of 16 percent and 24 percent in 1998–9 to 7 percent and 12 percent in 2004, respectively (table 5.4). The near-term debt service ratios of these countries are below the average for non-HIPC low-income countries.

Debt relief under the HIPC initiative has helped countries increase poverty-reducing spending. In the 27 countries that have reached the decision point, such spending rose from an average of 6.4 percent of GDP in 1999 to 7.9 percent in 2004—about four times the amount spent on debt service.⁶⁸ In absolute terms, poverty-reducing spending is estimated to have increased from nearly \$6.0 billion in 1999 to \$10.5 billion in 2004, and is projected to increase to \$14.5 billion in 2007 (see table 5.4).⁶⁹

Although creditor participation has improved, some non-Paris Club bilateral and commercial creditors have not committed to providing HIPC relief. Most of the costs attributable to bilateral creditors continue to be borne by members of the Paris Club. Commercial creditors represent less than 5 percent of the net present value cost of relief, in part because of measures by the Debt Reduction Facility for IDA-only countries that have reduced the stock of commercial debt in HIPCs. Moral suasion remains the principal measure for encouraging participation and discouraging litigation by remaining commercial creditors. With respect to multilateral debt, 23 of the 31 multilateral creditors have indicated their intent to participate in the initiative, representing more than 99 percent of the total debt relief required.

A key premise of the HIPC initiative is that debt relief should be additional to other forms of external financing assistance. An important issue is whether countries receiving

TABLE 5.4 Debt service is falling and poverty-reducing spending rising among the 27 HIPC countries that have reached their decision points (percent unless otherwise indicated)

Indicator	Actual						Estimated	Projected		
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Debt service (US\$ billions)	3.70	3.18	3.07	2.42	2.44	2.55				
Debt service after enhanced HIPC relief (US\$ billions)							2.63	2.49	2.55	2.78
Debt service/exports ^a	16.9	14.5	13.6	10.2	10.1	8.9	7.3	6.3	6.1	6.2
Debt service/government revenue ^a	25.2	21.8	21.9	16.5	15.0	13.4	11.7	9.5	9.0	9.0
Debt service/GDP ^a	3.9	3.4	3.3	2.5	2.4	2.2	2.0	1.7	1.6	1.6
Poverty-reducing expenditure (US\$ billions)		5.94	6.02	6.55	7.57	9.07	10.54	12.83	13.53	14.49
Poverty-reducing expenditure/government revenue ^a		40.9	42.9	44.8	46.6	47.6	46.8	49.1	47.5	46.7
Poverty-reducing expenditure/GDP ^a		6.4	6.4	6.8	7.4	7.8	7.9	8.6	8.4	8.4

Source: HIPC country documents and IMF staff estimates.

Note: Debt service data for 1998 and 1999 reflect debt relief already provided to Bolivia, Guyana, Mozambique, and Uganda under the original HIPC initiative. Data on poverty-reducing expenditure are not available for all countries, particularly for 2003–05. In aggregate, the last available period was used for future years, thus understating the likely level of poverty-reducing spending.

a. Weighted average.

HIPC debt relief are receiving additional resources, or whether debt relief crowds out other aid flows. Merely observing the size of flows does not provide conclusive evidence of additionality, as there is no way of knowing how much aid countries would have received without the HIPC initiative. There are also substantial difficulties in measurement because different donors account for debt relief in different ways. Debt relief is sometimes explicit, such as through grants for debt relief, and sometimes implicit, such as through debt service reductions.

The August 2004 HIPC status report, based on updates of debt stock and debt service indicators in post-completion point countries, found that the net present value of debt ratios had climbed since the completion points.⁷⁰ Most of the increase was due to interest and exchange rate changes, while high exports had significantly lowered debt ratios. Debt service ratios for these countries had also increased but remained close to 10 percent on average. While the low level was

due to HIPC debt relief and the high concessionality of new debt, the average change masked important differences between countries. Medium-term projections generally pointed to stable or declining trends in debt and debt service ratios. The review indicated that notwithstanding HIPC countries' high vulnerability to shocks, sound economic policies and close monitoring—using the proposed debt sustainability framework for low-income countries (see below)—would help prevent the reemergence of unsustainable debt.

Debt Sustainability

Continued measures are needed by HIPC countries and by creditors to ensure that debt sustainability is maintained after completion points, just as similar measures are needed for other low-income countries. The Boards of the IMF and World Bank have endorsed key elements of a proposed debt sustainability framework for low-income countries aimed at supporting these countries' efforts to achieve the MDGs

without creating future debt problems and keeping countries that have received debt relief under the HIPC initiative on a sustainable track. In guiding future financing decisions, the framework rests on three pillars:

- An assessment of debt sustainability guided by indicative country-specific debt burden thresholds related to the quality of their policies and institutions.
- A standardized, forward-looking analysis of debt and debt-service dynamics under a baseline scenario and in the face of plausible shocks.
- An appropriate borrowing (and lending) strategy that contains the risk of debt distress.

Building on initial Board discussions of the proposed framework in early 2004, and further considerations in September 2004, Bank and IMF staff are preparing a follow-up paper that attempts to resolve outstanding issues on the indicative debt burden thresholds, the interaction of the framework with the HIPC initiative, and the modalities for Bank-IMF collaboration in deriving common assessments of debt sustainability. It needs to be stressed, however, that debt sustainability is not only a resource flow issue. It also depends on increasing growth, diversifying exports, expanding access to global markets, and mitigating the effects of exogenous shocks.

IDA financial support to poor countries will now take systematic account of their vulnerability to debt. Debt sustainability will be the primary determinant of the grant and credit mix in IDA14, and the joint debt sustainability framework for low-income countries will form the analytical basis to link debt sustainability and grant eligibility.⁷¹ Countries facing the toughest debt problems—most of them in Sub-Saharan Africa—will get all their support in the form of grants, while countries less burdened by debt will receive IDA's highly concessional long-term loans, or in a few cases a mix of grants and loans. The resulting share of grants in IDA support over the next three years is expected to be about 30 percent.

Proposals for Additional Debt Relief

Some G-7 members have proposed mechanisms for additional debt relief (box 5.7). Further debt relief holds the promise of yielding additional development financing beyond what could be forthcoming in the form of additional gross flows, given the broad political support for debt relief. It could also reduce the remaining debt overhang and ease pressures to provide new aid to refinance existing debt service obligations (so-called defensive lending), enabling a more effective policy dialogue between donors and debtor countries. Debt relief also has the advantage that, to the extent that it is committed irrevocably up front, it can provide aid in a predictable and easy to use form.

There is a danger, however, that further debt relief might instead result in a diversion of resources that would have gone to increased direct aid flows. Furthermore, relative to the alternative of higher new aid flows, debt relief has a number of potential disadvantages. First, it allocates resources according to existing debt stocks rather than need or policy performance, and so may prove inconsistent with the principle of allocating assistance to countries where it would be most effective. Second, debt relief may reduce the scope for linking assistance to the maintenance of good policies, to the extent that an irrevocable commitment to debt relief is made upfront. Third, it may create expectations of further relief in the future, increasing the moral hazard associated with any subsequent lending and hindering the development of a credit culture. This could prompt creditors to reduce net lending in the future.

Any new debt relief initiative would leave an unfinished agenda. Further debt relief is inevitably only a small part of a broader agenda that involves stronger policies in developing countries, more and better-targeted development assistance, and a supportive international environment for growth.

BOX 5.7 Proposals for additional debt relief—moving beyond HIPC

Members of the G-7 have put forward a number of proposals for further debt relief beyond the enhanced HIPC initiative. Different motivations drive these proposals. Some proposals reflect a desire to provide additional resources to help low-income countries achieve the MDGs. Others see further debt reduction as a way of increasing the scope for new lending—under the proposed World Bank–IMF debt-sustainability framework—to low-income countries with relatively strong policies, to facilitate the development of a credit culture. Still others aim to eliminate the need for defensive lending and perpetual debt relief for HIPCs.

Motivations apart, the proposals differ importantly along several lines, including the scope and modality of debt relief, the conditionality to be applied, and the source or sources of financing. Differences include:

- Whether eligibility for relief should be restricted to HIPCs or be available to all low-income countries.
- Which institutions' debt should be relieved.
- What percentage of eligible debt should be relieved.
- Whether relief should take the form of reductions in debt stocks or debt service payments.
- The strictness of conditionality.
- How debt relief by international financial institutions will be financed—for example, with contributions from bilateral donors or by the institutions themselves. Some G-7 members have proposed that the IMF sell some of its gold reserves to cover its debt relief.

Source: IMF 2005.

Notes

1. DAC members' ODA consists of bilateral ODA—provided directly to developing countries that are on DAC's Part I list of aid recipients—and contributions to multilateral agencies. Disbursements of ODA by multilateral agencies may not equal the contributions they received from donors.

2. OECD (2005a). Paris Club (comprising bilateral donors) members recently agreed to forgive up to 80 percent of their debt claims on Iraq, adding \$12–\$17 billion to ODA flows in 2005–6 (in addition to the amounts discussed in the text). For many donors these flows will be in addition to their Monterrey commitments.

3. Between 2001 and 2003 military expenditures rose by 18 percent in real terms (Stockholm International Peace Research Institute 2005); such spending dwarfs aid flows. For example, in 2002 U.S. military spending was \$1,217 per capita and ODA was \$46 per capita. At \$358 per capita, EU military spending was also much larger than ODA per capita (Economists Allied for Arms Reduction 2004).

4. Oxfam International (2005).

5. European Commission (2004). In 2002 the European Commission adopted an interim target for ODA to average 0.39 percent of gross national income (GNI) by 2006.

6. Donors recently agreed to increase contributions to the International Development Association's 14th replenishment (IDA14) by more than 25 percent. Over the next three fiscal years—from 1 July 2005 to 30 June 2008—grants are expected to account for about 30 percent of IDA support.

7. Noncash assistance typically involves technical cooperation, emergency and distress relief, and food aid. Debt relief involves a net transfer of resources if debt is being serviced (that is, is not in arrears), but amounts to an accounting exercise if it is not.

8. The increase in real ODA between 2001 and 2003 was \$6.6 billion at 2002 prices and exchange rates. Debt relief increased by \$3.8 billion, technical cooperation by \$2.6 billion, and emergency and disaster relief and food aid by \$1.9 billion.

9. Data are for the 14 non-DAC donor countries for which the OECD collects data on development assistance.

10. The Forum on Partnerships for More Effective Development Cooperation, held in February 2005, brought together DAC members and a number of non-OECD countries involved in supporting development in developing countries. The forum sought to improve coordination and cooperation among the entire donor community, particularly through better information and knowledge sharing.

11. Middle-income countries receive about a third of aid. Although these countries are less dependent on aid, it plays an important role in catalyzing reforms, helping countries address issues of large pockets of poverty, and providing a buffer against shocks.

12. The increase in real net bilateral ODA between 2001 and 2003 was \$6.5 billion, with \$4.2 billion for debt relief and \$1.6 billion for emergency and disaster relief and food aid.

13. The corresponding real increase was \$4.4 billion in the Democratic Republic of Congo, \$225 million in Cameroon, \$344 million in Sudan, \$123 million in Tanzania, and \$199 million in Ethiopia.

14. All official flows (ODA and non-ODA) account for a slightly smaller share of resource flows—50 percent, as in figure 5.6—because non-ODA official flows are slightly negative.

15. Official data underestimate remittance flows, and unrecorded remittances may be larger than recorded remittances.

16. See World Bank (2004c) and chapter 2 for a detailed discussion of the private investment climate and its links to growth.

17. Development Committee (2005) analyzes the various proposed innovative mechanisms under discussion. See also Development Committee (2004) and Reisen (2004).

18. The IFFIm would be established as a U.K. charitable entity, essentially as a special-purpose vehicle for the Vaccine Fund. Negotiations are under way to establish a core group of donors to fund the pilot facility.

19. Reisen (2004).

20. Taxes that correct inefficiencies ultimately imply an increase in a country's real resources and the possibility of increased development financing. See Development Committee (2004) for a detailed discussion of the additionality of various innovative instruments.

21. Gap countries are countries that are ineligible for IDA financing (because their GNI per capita is above the IDA cutoff), other than on an exceptional basis, and that are not creditworthy

for normal borrowing from multilateral development banks.

22. UNMP (2005).

23. World Bank (2004b).

24. Some analysts have argued that developing countries often lack a minimum amount of capital—in terms of infrastructure, human capital, and public administration—to support modern production activity, so capital above a minimum threshold is needed to boost economic activity. According to that argument, the key to breaking out of such “poverty traps” is a large infusion of investment in physical and human capital, which must be funded predominantly by external sources given limited domestic capacity to save. See Sachs and others (2004) for a poverty trap perspective on Sub-Saharan Africa; see chapter 2 and Kraay and Raddatz (2005) for empirical evidence on poverty traps.

25. UNMP (2005) estimates that in Ghana the annual investment in roads required to meet the MDGs is 2.4 percent of GDP, over three times what the government can afford, and that in Uganda it is 5.4 percent of GDP, more than twice what can be financed domestically.

26. There is considerable debate in the recent economic literature on how aid affects growth. Some cross-country macro studies find an unambiguously positive relationship between aid and growth. Another set of studies shows more conditional results, with the effect dependent on the quality of policies and institutions or other country characteristics. A third set of studies finds no effect, or even a negative effect, of aid on growth.

27. Clemens, Radelet, and Bhavani (2004).

28. Development Committee (2004); Renzio (2004).

29. Levy (2004).

30. World Bank (2004a).

31. UNMP (2005).

32. Of the 47 countries with full PRSPs, 22 have produced at least one annual progress report.

33. See IMF and World Bank (2005) and chapter 2 for results from the just concluded World Bank–IMF poverty-reducing public spending tracking exercise for HIPCs.

34. See Alonso, Judge, and Klugman (2004) for a comparative analysis of PRSPs and budget linkages in four countries.

35. PRSCs have also facilitated donor coordination and increased aid for budget support. Bilateral donors providing budget support include Belgium, Ireland, the Netherlands, Sweden, the United Kingdom, and the United States.

36. Miovic (2004). Input-level data show that much larger amounts of resources have been channeled to basic health, education, and water and sanitation.

37. While the overall performance was stable, there were within-year fluctuations in some areas of the budget.

38. Alonso and Utz (2004).

39. Priority sectors are broad sectors—such as education, health, agriculture, and roads—that are assigned priority in budget allocations. Core priority areas are items within priority sectors, such as primary health care and primary school education. Per capita spending on priority sectors increased 53 percent between fiscal 1999 and 2002, while spending on core priority areas rose 77 percent. The much larger increase for core priority areas was due to the donor-funded Primary Education Development Program.

40. Tanzania has about 650 donor projects being implemented by sector ministries and local governments. One of the four priorities of the Tanzanian assistance strategy agreed to in 2003 by the government and development partners is to integrate donor funds, including projects, with the government budget. To that end, the government has created a mechanism linking donor funds to government accounts, for donors to use in channeling funds to projects, nongovernmental organizations, and the private sector. It has also provided relevant training to interested donor agencies. By August 2004, however, only four of Tanzania's development partners had indicated their readiness to use this mechanism. See Peretz and Wangwe (2004).

41. Alonso (2004). Although priority sectors are seeing higher spending, their share in the total budget is largely unchanged, even with HIPC funds earmarked for priority sectors. Real spending—including real per capita spending—on priority sectors and core priority areas increased between the start of the PRS, in 1999, and 2002. Between 1998 and 2002 real per capita spending on priority sectors and core priority areas doubled. Allocations of increased spending between core priority areas have been quite uneven, however.

42. As noted, there is considerable debate in recent literature on the impact of aid on growth. A recent study by Dollar and Levin (2005) adds micro evidence to the macro results in the literature. The study finds a strong link between institutional quality and aid-financed project outcomes. The results support the findings of other cross-

country analyses that find aid to be effective in good institutional environments. The study finds the most robust results for the rule of law. In addition, geography matters: Projects in Sub-Saharan countries have less successful outcomes (although tropical location does not significantly affect outcomes). The study also finds that different institutions have different effects on project success. For example, better democratic political institutions result in better outcomes for policy-based loans, whereas the success of project loans is facilitated by stronger property rights and rule of law. This is consistent with the growth literature, which finds a favorable link between property rights and economic growth.

43. Based on Dollar and Levin (2004).

44. Flexible ODA is defined here as total ODA less special-purpose grants—such as technical cooperation, debt relief, emergency and disaster relief, and food aid.

45. Difficult partnership countries (which include low-income countries under stress, or LICUS) are low-income countries with weak institutions, defined as those with Country Policy and Institutional Assessment (CPIA) scores in the bottom two quintiles.

46. Levin and Dollar (2005).

47. This model of aid allocation does not reflect the costs of conflict and the benefits of conflict prevention for growth and poverty reduction. See Chalmers (2004) and Chauvet and Collier (2004) for evidence on the potentially large effects of aid in difficult partnership countries. Aid reduces the risk of conflict by raising economic growth.

48. Kang and Meernik (2004).

49. Collier and others (2003).

50. By contrast, aid has typically been inadequate and mistimed, phasing out just when it should be phasing in.

51. See OECD (2005c) for a discussion of how donors are moving forward on improving the effectiveness of their aid to fragile states.

52. Difficult partnership countries, especially countries just emerging from conflicts and post-conflict countries, often need to rebuild basic state, civil society, and private sector institutions.

53. Knack and Rehman (2004).

54. Felix (2005).

55. A 2001 DAC High Level Meeting adopted recommendations to untie ODA to the least developed countries.

56. OECD (2004a).

57. Aryeetey, Osei, and Quartey (2003) find the savings to be in the range of 11–25 percent; Jepma (1991) estimates 15–30 percent.

58. See also table 5.2 and OECD (2005e).

59. Gemmell and McGillivray (1998).

60. See Bulir and Hamann (2003, 2005) and Bulir and Lane (2002).

61. World Bank (2005c); Pallage and Robe (2001).

62. OECD (2004b, 2005d). The WP-EFF is a group of bilateral and multilateral donors that formed after the Rome forum to monitor and assist global progress on harmonization and alignment.

63. The countries were Bangladesh, Bolivia, Cambodia, Ethiopia, Fiji, the Kyrgyz Republic, Morocco, Mozambique, Nicaragua, Niger, Senegal, Tanzania, Vietnam, and Zambia. These countries, along with Mali, are associated with the work of the Task Team on Harmonization and Alignment, a subgroup of the WP-EFF. In addition to the preceding 15 countries, South

Africa participates in the Joint Venture on Public Financial Management, another group under the WP-EFF.

64. This is similar, for example, to when donors disagree with specific aspects of partner country policies (such as resettlement policies).

65. The SPA Budget Support survey finds that for Africa as a whole, budget support increased from about \$1.5 billion in 2002 to about \$2.5 billion in 2003.

66. OECD (2004b).

67. IMF and World Bank (2004a).

68. The definition of poverty-reducing spending varies by country, but commonly includes primary education, basic health, and rural development.

69. Some countries are implementing public expenditure management systems to ensure the efficiency of poverty-reducing spending. See IMF and World Bank (2005).

70. IMF and World Bank (2004a).

71. IDA (2004).

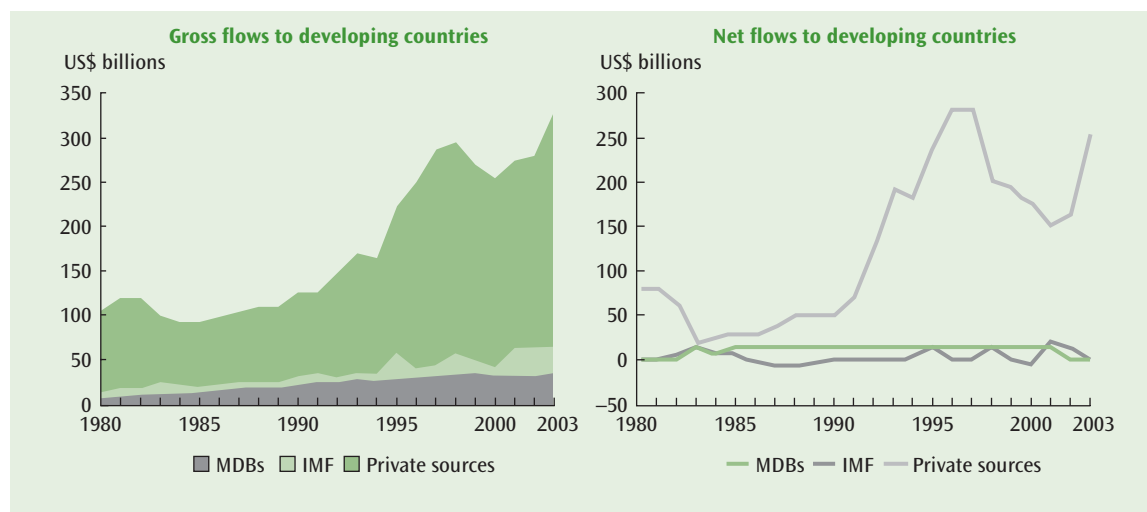
Strengthening and Sharpening Support from International Financial Institutions

This chapter analyzes the support provided by international financial institutions to help developing countries achieve the Millennium Development Goals (MDGs) and related development objectives, and sets out priorities for strengthening and sharpening that support. The focus is on the five largest multilateral development banks—the African Development Bank (AfDB), Asian Development Bank (ADB), European Bank for Reconstruction and Development (EBRD), Inter-American Development Bank (IDB), and World Bank—and the International Monetary Fund (IMF). The discussion is structured around the four-pillared organizational framework developed in the *Global Monitoring Report 2004*: country focus, global and sectoral programs, partnerships, and results.

In applying the framework, the chapter reflects the similarities across the international financial institutions and common directions of change, but also the differences—especially in the ways the multilateral development banks and the IMF contribute to progress on the MDGs. Operating in some ways like the aid agencies considered in chapter 5, the banks work

through a large variety of instruments and sectors tailored to country circumstances through decentralized processes; to a large extent the key to understanding their contribution lies in understanding how and how well those processes are working. The IMF's product line is simpler, with programs focused on substantive policy issues at a higher level of execution.

To provide historical context for the chapter, figure 6.1 shows development finance flows over the past 25 years. During that time there was a significant increase in private sector flows—albeit with considerable fluctuations. Measured by gross disbursements, the contribution of the multilateral development banks grew gradually but steadily through the late 1990s (peaking in 1999) while shrinking relative to private finance—increasing the banks' strategic and catalytic role in supporting policy development and institution building. Net flows also peaked by the end of the decade, turning negative in 2002 for the ADB and World Bank—reflecting transactions with middle-income borrowers. IMF support was sometimes countercyclical relative to private flows, and sometimes procyclical, with net flows negative in some years.

FIGURE 6.1 Financial flows from the Big 5 multilateral development banks, IMF, and private sources

Source: World Bank Debtor Reporting System.

Multilateral Development Banks

In line with the model set out in earlier chapters, the multilateral development banks contribute to the achievement of the MDGs through their support for country policies, institutions, and investments and for global and regional public goods. This section addresses how and how well the banks carry out these tasks. The comparative profile in box 6.1 provides a perspective for interpreting the observations on the individual banks, especially with respect to their mix of low- and middle-income borrowers.

Country Programs

In exploring how the multilateral development banks are helping their developing member countries achieve the MDGs, this section examines how the banks approach country ownership, strategies, financial support, and analytic and capacity-building support. It reflects the view that the banks' contribution to achieving the MDGs lies in the relevance of their country programs—especially the links between their country strategies and national

poverty reduction strategies (PRs) or other national strategies—and the implementation quality of those programs. The analysis draws on findings by the banks' independent evaluation departments and indicates plans for further evaluation studies that can inform future *Global Monitoring Reports*.

COUNTRY OWNERSHIP

All the multilateral development banks recognize the importance of country ownership, with an emerging consensus that country demand, balanced with staff analysis, should form the basis for the policy dialogue.

Low-income countries. The 61 low-income countries that are members of multilateral development banks are home to 2.2 billion people. Their populations range from around 150,000 people in São Tomé and Príncipe to more than 1 billion in India. They are islands, landlocked, peninsulas, and continents, with tremendous diversity across and within countries. Each faces unique development challenges, sharing a common statistic of annual per capita income of \$765 or less. They contain more than 70 percent of the world's people

BOX 6.1 Profile of the “Big 5” multilateral development banks

Together the five biggest multilateral development banks—the African Development Bank (AfDB), Asian Development Bank (ADB), European Bank for Reconstruction and Development (EBRD), Inter-American Development Bank (IDB), and World Bank—commit and disburse about \$35 billion a year. These banks share many characteristics. But they also have differences—in country coverage, mandate, voice and ownership, and location of work—that influence how they respond to the challenge of helping countries achieve the MDGs and other development goals.

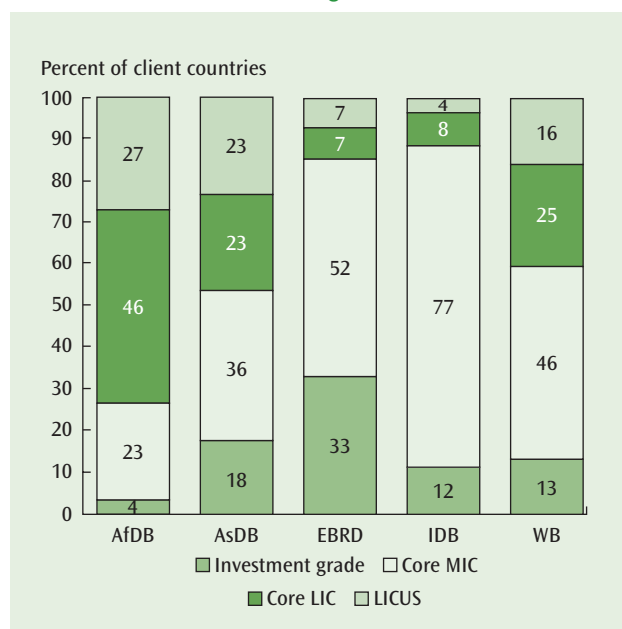
Country coverage. Most developing countries are eligible to borrow from two of the Big 5 multilateral development banks: the World Bank and their regional bank. Exceptions include countries in the Pacific that are members of the ADB and not the World Bank (Cook Islands, Nauru, Tuvalu), countries that are members only of the World Bank (Antigua and Barbuda, Dominica, Grenada, Iran, Iraq, Jordan, Lebanon, St. Kitts and Nevis, St. Lucia, St. Vincent and Grenadines, Syria, Turkey, Yemen), and countries that are members of the ADB, EBRD, and World Bank (Azerbaijan, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, Uzbekistan).

Differences in the income mix of the banks’ developing country members translate into very different client bases. The AfDB has the largest shares of low-income members, while the EBRD and IDB have the largest shares of middle-income members (see top figure). The ADB and the World Bank are in the middle. Accordingly, average income levels vary significantly for bank clients (see second figure).

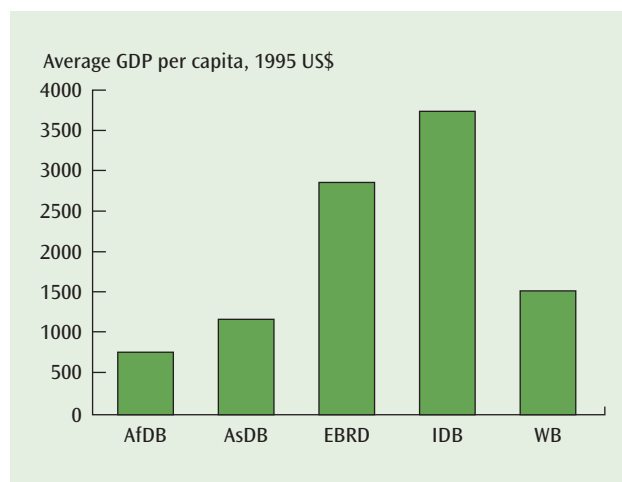
The relative importance of different funding sources also varies for the different categories of clients. For investment grade and other emerging market economies, private financing provides up to 95 percent of inflows. For the others the private share is much lower. These variations translate into differences across countries in the importance of the multilateral development banks’ financing role relative to their policy and catalytic role.

A third consideration is the size of borrowers, particularly between large states (more than 100 million people) and small states (less than 1.5 million people). There are nine large states, with one in the AfDB (Nigeria), five in the ADB (Bangladesh, China, India, Indonesia, Pakistan), one in the EBRD (Russia), and two in the IDB (Brazil, Mexico). Small states cut across the spectrum of country classifications, with Barbados being investment grade and the Solomon Islands a low-income country under stress, with most falling in between—whether middle income or low income—and more aid-dependent than larger states. Small states also cut across the multilateral development banks, accounting for 20–30 percent of country clients in the AfDB, IDB, and World Bank and more than 35 percent in the ADB, but less than 5 percent in the EBRD (see top figure, next page).

Differences in Big 5 client bases



Average incomes of Big 5 client countries



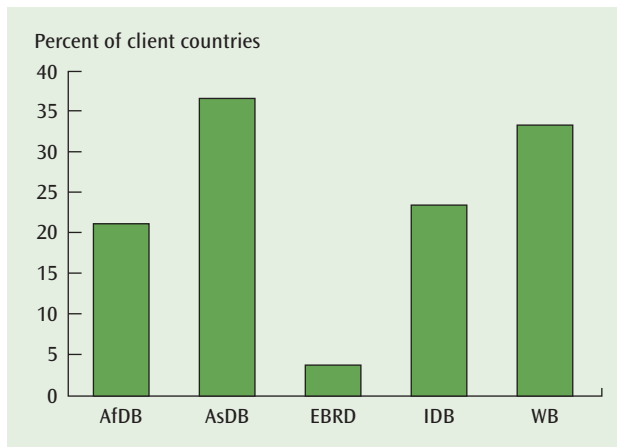
BOX 6.1 (continued)

Mandate. The mandates of the AfDB, ADB, IDB, and World Bank are similar: promoting growth and development and reducing poverty. The EBRD's mandate is to promote transition and private sector development. The mandates of the EBRD and AfDB, ADB, and IDB also include an important regional dimension—to focus on regional and sub-regional projects, programs, and trade.

Voice. The Big 5 differ in their borrowers' shares of bank ownership, ranging from low in the EBRD to high in the AfDB (see middle figure, this page). But the influence of nonborrowers is affected by the role played by the banks' concessional windows, which are heavily supported by nonborrowing donors. In the AfDB concessional lending accounts for 44 percent of total lending; in the World Bank, 40 percent; and in the ADB, 27 percent. The IDB has a concessional Fund for Special Operations that accounts for 7 percent of all lending. Also relevant is the process for selecting the banks' presidents—with the heads of the ADB, EBRD, and World Bank traditionally selected from a developed country and the heads of the AfDB and IDB from a developing country.

Location of work. A final issue is the location of the banks and their work. The headquarters of the EBRD, IDB, and World Bank are in G-7 countries, while the AfDB and ADB are in borrower countries. Equally important is the location of work and staff. Two parameters are key: coverage of field offices and roles and responsibilities. Most of the Big 5 have full or fairly full field presence in their developing member countries (see last figure, this page). The exception is the AfDB, which had closed its field offices because of problems but is establishing new ones in 25 countries, following the example of the other Big 5 and lessons learned from recently established offices in Egypt, Ethiopia, Gabon, Mozambique, Nigeria, Senegal, Tanzania, Tunisia, and Uganda. All the Big 5 consider project administration a key task of their country offices. But the ADB, EBRD, and World Bank also see a critical role for their country offices in strategy formulation and program design, with most World Bank country directors located outside Washington, D.C.

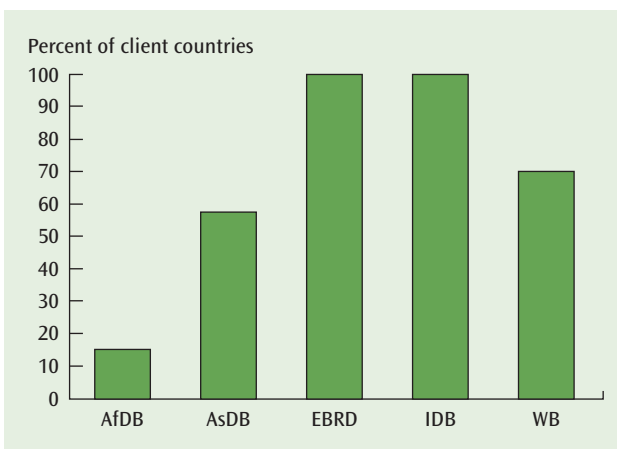
Small states in the Big 5 (percentage of client countries)



Borrower shares in Big 5 ownership



Big 5 decentralization
(percentage of member countries with bank office)



Source: Staff of the Big 5 multilateral development banks.

living on less than \$1 per day and 60 percent of those living on less than \$2 per day. They are eligible for concessional financing from the multilateral development banks—from the World Bank's International Development Association (IDA) and, in their respective regions, from the African Development Fund, Asian Development Fund, and Inter-American Development Bank's Fund for Special Operations. Low-income members of the EBRD are supported by the Early Transition Countries initiative, under which the EBRD accepts higher risks in the projects it finances.

Each of these facilities explicitly recognizes PRSs (or national strategies) as the vehicle for the banks to work with in low-income countries on their MDG priorities.¹ All the banks are committed to using the PRS process in the dialogue on, and as the starting point of, their country strategies. Recent reviews of the PRS approach carried out by the independent evaluation departments of the World Bank (Operations Evaluation Department, or OED) and IMF (Independent Evaluation Office, or IEO) highlight strengths and weaknesses of the PRS process, as well as priorities for change.² (See box 6.2 for the findings of the OED review; the IEO review is discussed in box 6.11.) Building on these reviews and their recommendations, steps are being taken to strike a better balance between country ownership and external involvement—including by international financial institutions—and to help countries broaden domestic participation, develop and monitor their strategies, strengthen analysis of the sources of growth and poverty reduction, link ambitious objectives with available resources and capacity constraints, and set out operational paths for sustained implementation.

Low-income countries under stress. Among low-income countries, low-income countries under stress (LICUS) are the most fragile—often affected by conflict, and with the weakest governance, policies, and institutions. This translates into severely limited progress on and prospects for poverty reduc-

tion and the other MDGs. The more than 400 million poor people living in these countries share bleak socioeconomic indicators, with per capita income levels half, and child mortality rates double, those in other low-income countries. Six LICUS are also small states—Comoros, The Gambia, Guinea-Bissau, São Tomé and Príncipe, Solomon Islands, and Timor Leste—making them particularly vulnerable to economic shocks and volatility; they also face unique challenges in sustaining support from donors. Clearly, LICUS face the most difficult circumstances for meeting the MDGs and other development goals. Hence the importance of focused attention on their special needs, a central topic of the recent Senior-Level Forum on Development Effectiveness in Fragile States hosted by the U.K. Department for International Development (DFID) and co-sponsored by the European Commission, OECD Development Assistance Committee (DAC), United Nations Development Programme (UNDP), and World Bank.³ The forum led to support by the OECD DAC High Level Meeting in March 2005 for a new set of principles for international engagement in fragile states, and an agreement to pilot them in donor programs in seven countries.⁴

Among the 25 LICUS in fiscal 2005, the World Bank has been working closely with 15 focus countries, while providing more general support to the larger group.⁵ For the 8 focus countries where the Bank had previously disengaged, there have recently been country missions to all, along with analytic work to regain basic knowledge. These reengagement activities have proved critical in positioning the Bank to move quickly when necessary, as has happened recently in Haiti, Liberia, and Sudan. Of the \$25 million in the LICUS implementation trust fund approved by the Bank's Board in March 2004 to support governance and social service delivery in countries in arrears to the Bank, grants totaling \$20 million have been approved for the Central African Republic, Comoros, Haiti, Liberia, Somalia, and Sudan.

BOX 6.2 Independent evaluation of the World Bank's role in poverty reduction strategies

A recent review by the World Bank's independent Operations Evaluation Department (OED) found that the poverty reduction strategy (PRS) initiative is relevant to the development challenges in low-income countries and warrants continued World Bank support. But according to OED, the initiative has not yet fulfilled its full potential to enhance poverty reduction efforts in low-income countries because it has led countries to focus more on completing documents—which give them access to resources—than on improving domestic policies and practices. Other identified weaknesses include the absence of an effective mechanism for adapting the initiative to different country conditions, especially in the context of the weak public sector capacity found in most low-income countries. Moreover, most PRSs pay too little attention to infrastructure, rural development, and other areas with substantial growth and poverty reduction potential. External partners have supported PRS formulation, and changes in donor processes are evident—but donors have not specifically defined whether and how they should change the content of their programs to reflect PRSs.

The review also assessed the World Bank's role in the PRS initiative. Most problematic in OED's view, the Bank's process for presenting PRSs to its Board undermines country ownership. The Joint Staff Assessment mechanism was designed to provide the Bank and IMF Boards with an assessment of the soundness of a country's PRS as a basis for support; it was also designed to provide feedback on how a PRS could be improved over time. But OED found these assessments to be of mixed analytic quality and coverage, with limited awareness of their findings and recommendations among stakeholders.

On the positive side, OED found that the World Bank has effectively supported national stakeholders in PRS formulation, that Bank lending since the launch of the initiative has increased for countries with PRSs completed through 2003, and that economic and sector work has added value to country planning, with poverty assessments and public expenditure reviews useful for PRS formulation. OED also found that the Bank has promoted PRSs as a coordinating framework for donor activities—although apparently with limited success, in light of the evidence.

Going forward, OED recommends that the World Bank make changes in:

- *PRS content*, by helping countries address key analytic gaps about the poverty impact of policies and programs.
- *PRS process*, by emphasizing ways of improving country processes for planning, implementing, and monitoring public actions geared toward poverty reduction; placing less emphasis on completion of documents; and developing a review procedure that is more supportive of ownership and more effectively linked to decisions about the World Bank's program.
- *Partnerships and alignment*, by assisting countries in using the PRS as a partnership framework and encouraging government-led aid management and selectivity; and better integrating its assistance with the efforts of other partners.

Source: OED 2004e.

Of the LICUS, 14 are also members of the AfDB, 9 of the ADB, 3 of the EBRD (of which 2 are also members of the ADB), and 1 (Haiti) of the IDB. Responding to the African Development Fund's Deputies in the context of the recent replenishment process, the AfDB is preparing a comprehensive strategy for institutional engage-

ment, with implementation of the strategy to begin later this year. In the meantime the AfDB is continuing to implement its Post-Conflict Country Facility, approved by its Board in July 2004.⁶

The ADB is developing an approach for working with fragile states in the context of the Asian Development Fund's IX replenish-

ment. The approach will emphasize highly focused interventions at points where assistance can be used effectively, with an increased emphasis on strategic partnerships. Other issues under consideration include the importance of an initial assessment of absorptive capacity, use of stakeholder and partner analysis to refine interventions, instruments that allow flexibility in situations where existing institutions are essentially nonfunctional, and the potential role of subregional cooperation.

Middle-income countries. Some 2.9 billion people live in middle-income countries, which range in size from the very small, such as Dominica (with less than 100,000 people), to the very large, such as China (with almost 1.3 billion people). Relative to low-income countries, middle-income countries have greater public and private sector capacity, more resources, and better prospects, although there are large variations across middle-income countries. Though they have less poverty than low-income countries, middle-income countries still have too much: They are home to almost 30 percent of all people living on less than \$1 a day and 40 percent living on less than \$2 a day.

Few middle-income countries are bound by the PRS process, as they are generally not eligible for concessional funding.⁷ But they have long been in the development driver's seat and are articulate in expressing their views. Most set out clear plans for growth and poverty reduction in the context of their annual budget and planning documents, which in turn provide the starting point for their dialogue with multilateral development banks (and donors). Multilateral development banks help middle-income countries through a combination of knowledge, lending, and financial services tailored to each country's needs and circumstances. They strive to ensure that their country strategies respond to the countries' diverse needs, as covered by their mandates. By supporting policy and institutional reforms, they aim to catalyze private investment and support from

other development partners. The access to international capital markets of many middle-income countries reinforces the banks' shared premise that their job is to add value that private markets cannot or will not—crowding in private sector support, not crowding it out—a factor to be considered when reviewing trends in lending and net transfers.

COUNTRY STRATEGIES

The country strategy process forms the basis for multilateral development banks' support for country development, and in turn for the MDGs. In each case the process begins with the country's own priorities—as expressed in PRSs or similar national strategies in low-income countries (including plans for Early Transition Countries in the EBRD) and country plans in middle-income countries. The process takes into account participatory approaches and performance under earlier strategies and reflects diagnostic analyses by the country, the bank, and partners. Options for future support are set out, reflecting the likelihood of success in contributing to sustained growth, the MDGs, and other development goals. Throughout this process, the banks' financial, analytic, and capacity building support is customized to country needs, aimed at ensuring the most effective package in light of the priorities articulated by the country.

All multilateral development banks have evaluation departments that assess their strategies upon program completion, affording opportunities to test and validate results—including with respect to the banks' contributions to the MDGs—and lessons for the future (table 6.1). A recent OED retrospective concluded that roughly two-thirds of the 70 World Bank country assistance programs it had reviewed over the past decade had satisfactory outcomes, with tailoring to country contexts, strong knowledge bases, and realistic policy outlooks considered critical success factors.⁸ Conversely, the absence of these factors was an important ingredient in the third of the programs judged unsatisfactory.

TABLE 6.1 Country strategies of multilateral development banks

Issue	AfDB Country Strategy Paper	ADB Country Strategy Paper	EBRD Country Strategy	IDB Country Strategy	World Bank Country Assistance Strategy
Basis for strategy's country vision and objective	PRS for low-income countries; national development plans for middle-income countries	PRS or national strategy for low-income countries; country documents for middle-income countries	PRS or national strategy for Early Transition Countries; country documents for middle-income countries	PRS for low-income countries; country documents for middle-income countries	PRS for low-income countries; country documents for middle-income countries
Frequency of bank strategy	Every 3 years	Every 3–5 years	Every 2 years	With every new government	Every 4 years
Progress report	Annual	Annual	Annual	Annual	Every 2 years
Results-based strategy?	Being launched in 2005	1 pilot completed; 2 under way	No	No	7 pilots completed; assessment under way
Strategy completion report?	To be launched with results-based strategies	Under consideration as part of results-based strategies	No, but lessons reflected in new strategies	No, but lessons reflected in new strategies	7 completed; discussed with Board
Independent evaluation ^a	5 completed; 4 under way	8 completed; 3 under way	2 completed	Conducted for every strategy; 17 completed	Conducted every 8–10 years; 70 completed
Overall strategy retrospective?	Under way	Under consideration	Every 5 years	No	Every 3–4 years

Source: Staff of the Big 5 multilateral development banks.

a. Country program evaluations carried out by the banks' independent evaluation departments are available at www.afdb.org; www.adb.org; www.ebrd.com; www.iadb.org; and www.worldbank.org.

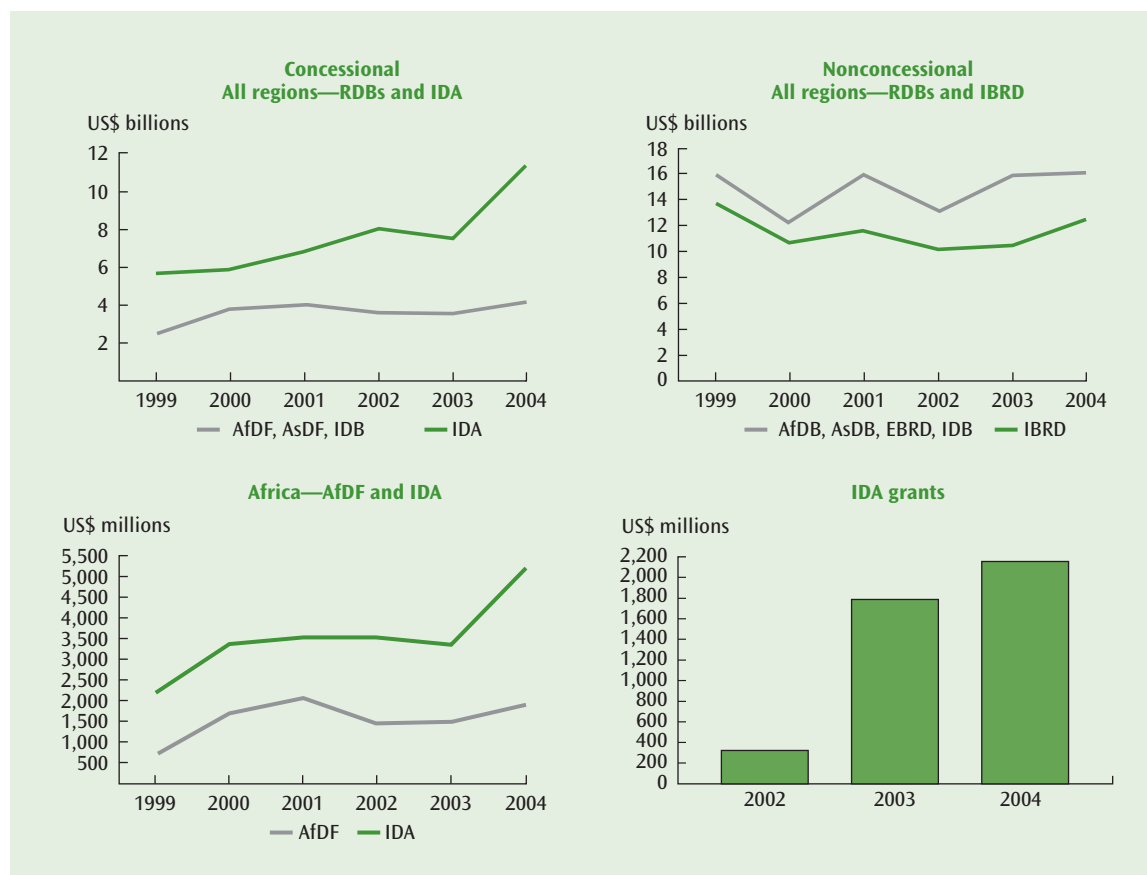
Looking to improve their effectiveness, the banks are increasingly focused on results, with the AfDB, ADB, and World Bank piloting results-based strategies. The aim is to sharpen the relevance of the banks' country support programs by focusing on interventions with the greatest expected impacts and to improve their implementation through enhanced monitoring and evaluation using clearly identified indicators and baselines. The EBRD's country strategies do not have results indicators as such, but they do contain transition indicators, which are also included in unit business plans. The IDB's Office of Evaluation and Oversight (OVE) has consistently identified the need for better "evaluability" of

the bank's country strategies and projects, including better results frameworks in country strategies and indicators for measuring progress.⁹

FINANCIAL SUPPORT

Multilateral development banks provide financial support through lending, grants, and debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative.

Lending. Lending by multilateral development banks serves two development purposes: financial, and policy and institutional. Recent growth in concessional lending commitments has been driven by IDA, with support for Sub-Saharan Africa growing

FIGURE 6.2 Trends in lending and grant commitments by multilateral development banks

Source: Staff of the Big 5 multilateral development banks.

Note: Data are for calendar years.

sharply in 2000 and 2004, and for East and South Asia in 2004 (figure 6.2). Commitments for nonconcessional lending have been more volatile. World Bank lending commitments have fluctuated narrowly, following a sharp correction from a spike in policy-based lending in 1998–9 that reflected turbulent conditions in global financial markets for many emerging market economies. For the regional development banks, trends in nonconcessional lending have been driven by substantial annual variations in commitments by the IDB, largely associated with emergency lending, and strong growth in EBRD commitments, in part, reflecting the appreciation of the euro, in which many loans are denominated.

For many years there was a proliferation of lending instruments among the multilateral development banks, responding to specific requests from shareholders and clients. More recently, attention has focused on the two main kinds of instruments—project-based and policy-based lending—with the others recognized as variations on these two.¹⁰ All the banks offer project-based lending (or investment lending, as it is often called). The EBRD does not offer policy-based lending, but it does have a substantial program in equities, equity funds, and guarantees.

Though there are many specific differences between project-based and policy-based lending, they are fundamentally distinguished by the rules governing the use of the funds they

provide, with disbursements of project-based lending historically tied to complex requirements for procurement, financial management, and environmental assessment, and policy-based lending disbursed in a more untied manner, albeit associated with policy conditionality.¹¹ Recent reforms have narrowed the differences between the two instruments. Table 6.2 summarizes the status quo in each of the banks, illustrating the trend toward greater flexibility for both project-based and policy-based lending:

- For project-based lending, reforms are moving the banks in the direction of sectorwide approaches (SWAp) and related approaches, allowing greater reliance on country systems—where the systems meet agreed standards—and in turn encouraging the banks to do more to help countries meet those standards.
- For policy-based lending, reforms are moving the banks toward streamlining conditionality, relying more on country ownership and selectivity to align flows of financial resources with the policies and institutions needed to ensure their effective use—and in turn encouraging the banks to help countries design and implement the needed reforms, often in advance of actual lending.

Grants. Multilateral development banks have long provided grant facilities, whether funded out of net income or donor funds. Traditionally, these have taken the form of small grants to countries, public agencies, and private entities to carry out specific tasks. Such grant funding continues at all the banks—including on a large scale through the IDB's Multilateral Investment Fund (MIF), which together with its partners has directed more than \$2 billion in technical assistance and investment projects for private sector development. Replenishment negotiations for MIF II are expected to be finalized in April 2005, with a clear focus on poverty reduction and economic

growth and an enhanced focus on measurable results.

Grant funding to public agencies took a giant step under the IDA13 replenishment, allowing for 18–21 percent of the resource envelope to be used for grants. The African and Asian Development Funds have taken similar approaches. Under the recently completed IDA14 replenishment, concerns about debt sustainability led to the expansion of grants and mainstreaming of their use for eligible countries, based on the World Bank–IMF debt sustainability framework (box 6.3; see also figure 6.2). Grants under the African Development Fund X replenishment will follow the same approach, with the fund using its own performance assessment ratings for eligible member countries. Similarly, the grants program under the Asian Development Fund IX replenishment aims to reduce the debt burden of development finance in the region's poorest countries, help poor countries accelerate their transition from postconflict situations to peace and stability, combat HIV/AIDS and other infectious diseases, and undertake priority technical assistance.

The HIPC Initiative and debt sustainability.

Along with the World Bank and IMF, the regional multilateral development banks have participated in the HIPC Initiative. The estimated combined cost to AfDB and IDB broadly equals the cost to the IMF and is half the size of the cost to the World Bank. The ADB is agreeable, in principle, to consider HIPC relief; however, none of its members has requested it.

Cooperation on debt relief and sustainability has taken on a new dimension, with the African and Asian Development Funds and IDA starting to allocate grants and credits based on debt sustainability considerations, and with announcements by the G-7 and others of their interest in further debt relief. Plans are under way for the regional development banks to collaborate on debt sustainability analysis—using the

TABLE 6.2 Lending instruments of multilateral development banks

	AfDB	ADB	EBRD	IDB	World Bank
Project-based lending					
Available?	Yes	Yes	Yes	Yes	Yes
Share of commitments in fiscal 2004 (percent)	77	81	81 ^a	71	78 (IDA) 61 (IBRD)
Recent reforms	Sectorwide approaches (SWAps)	SWAps; scope for use identified		SWAps; liberalization of expenditure eligibility	SWAps; liberalization of expenditure eligibility
Forward agenda	Simplification	Developing similar proposals on liberalizing expenditure eligibility		Eliminating minimum disbursement periods and “matrix” for foreign exchange financing; ^b increasing use of country systems	Increasing use of country systems in procurement; piloting use of country systems for environmental and social safeguards; reviewing conditionality
Policy-based lending					
Available?	Yes	Yes	No	Yes	Yes
Share of commitments in fiscal 2004 (percent)	23	19		29	22 (IDA) 39 (IBRD)
Statutory limit on amount or share (percent unless otherwise indicated)	25	20		Under New Lending Framework (NLF); ^b ordinary capital, \$9.8 billion in 2005–08; Fund for Special Operations (FSO), \$100 million a year	Shares monitored regularly ^c
Recent reforms	Development budget support loan policy	Scope for use of program-based approaches identified		None	From adjustment lending to development policy lending
Single-tranche operations permitted?	Yes	Yes		Yes for ordinary capital, under NLF; ^b No for FSO	Yes
Stance on conditionality	Streamlined: fewer and simpler	Country ownership essential		None explicit	Minimize legally binding conditions
Forward agenda	Further streamlining of conditionality	Review of program-based approaches under way		NLF eliminates limits on disbursement periods ^b	Review of conditionality under way

Source: Staff of the Big 5 multilateral development banks.

a. Remainder is equities, equity funds, and guarantees.

b. Pending approval by Board of Governors.

c. With regard to IDA, the IDA14 Deputies noted that Development Policy Operations (DPOs) should remain below 30 percent of total IDA commitments during the IDA-14 period. Management will monitor annually the overall share of DPOs in IDA countries. If it is projected that it could exceed 30 percent for any year, management will report that projection to the Executive Directors for review and guidance.

BOX 6.3 Grant financing in the African and Asian Development Funds and IDA

Recent empirical research has emphasized the need to fully consider the specific factors that affect debt sustainability in low-income countries. It calls for country-specific external debt thresholds that take into account the importance of policies and exogenous shocks. This recommendation emerges from the research finding that the risk of debt distress in low-income countries is inversely correlated with the quality of policies and institutions in these countries, and positively correlated with the severity of shocks that may affect them. This research has also formed the basis for a new joint World Bank–IMF debt sustainability framework for low-income countries. Additional analysis of the risks associated with exogenous shocks and how country responses might be strengthened is under way—with due consideration being given to the role to be played by the IMF and other partners.

African Development Fund. During the recently concluded discussions for the African Development Fund X replenishment, donors recommended that terms of financing be based on analyses of country prospects for debt sustainability, and it was agreed that eligibility for the fund's grants will be based on the World Bank–IMF debt sustainability framework. This means that eligibility will be guided by the same policy-dependent external debt thresholds as used for IDA14, although the African Development Fund will continue using its own country policy and institutional assessments to evaluate the performance of its member countries. Meanwhile, the share of grants has been more than doubled under this replenishment, to nearly 45 percent. Under the African Development Fund IX replenishment, as under IDA13, the grant share was limited to 18–21 percent of total resources and covered multiple objectives.

Asian Development Fund. Negotiations for the Asian Development Fund IX replenishment were concluded before the IDA14 and African Development Fund X negotiations were finalized. The Asian Development Fund's IX grants program is similar to the IDA13 and African Development Fund IX programs, incorporating a 21 percent limit on the overall grant share and broad coverage, including grants for debt-vulnerable poorest countries, postconflict countries, HIV/AIDS operations, and priority technical assistance. Donors recommended that the Asian Development Fund IX grants program be assessed during the fund's midterm review and that the fund coordinate closely with the World Bank and IMF on debt sustainability issues.

IDA. Participants in the IDA14 replenishment discussions recommended that debt sustainability be the primary determinant of the program's grant and credit mix. They agreed that IDA should adopt the Bank–IMF debt sustainability framework for low-income countries as the analytic basis to link debt sustainability and grant eligibility in IDA14. Therefore, unlike in IDA13, grants in IDA14 will no longer be allocated according to multiple, special-purpose eligibility criteria. In IDA13 the overall grant share was expected to fall between 18 and 21 percent of the total resource envelope, covering postconflict countries, countries with per capita gross national income below \$360 a year, debt-vulnerable poorest countries, and HIV/AIDS and natural disaster relief projects. Under the new grant allocation system the share of grants in total IDA financing will emerge from a country by country analysis of the risk of debt distress. The resulting overall grant share is expected to be around 30 percent.

Sources: Kraay and Nehru 2004; IMF and World Bank 2004a; African Development Fund 2004; Asian Development Fund 2004; World Bank 2005f.

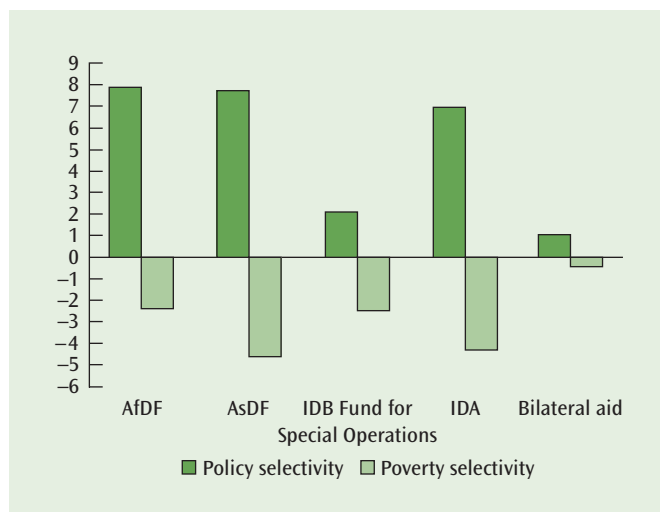
new debt sustainability framework (see box 6.3)—to provide a common platform for judgments on the mix of financial assistance provided to low-income countries. This also moves in the direction previously recom-

mended by OED, which had found that the World Bank and its partners did not always calibrate the size and financing of their assistance to recipients' debt carrying capacity.¹²

Cross-country determinants of financial support. While within-country lending and other resource allocation decisions are determined through country strategy and programming processes, cross-country allocations are determined differently. To allocate their scarce concessional funds in low-income countries, the four banks with concessional windows—the AfDB, ADB, IDB, and World Bank—follow broadly similar performance-based allocation processes. Country policy and institutional assessments are carried out by staff as part of an allocation formula that also takes into account population, degree of poverty, and track record for effective use of multilateral development bank funds. As discussed elsewhere in this report, the criteria used by the banks are converging, as are the scores for countries rated by two banks.

Recent research has examined the selectivity of the concessional assistance provided by the multilateral development banks and other agencies. The findings suggest that selectivity in aid allocation by the banks, as measured by the policy and poverty elasticities of their aid, is generally high—both absolutely and relative to bilateral donors—and has held up well in recent years, with a modest trend toward further improvement (figure 6.3; see chapter 5, table 5.1, for more details on the calculation of these elasticities). The Asian Development Fund's allocations are the most targeted to the poor countries within its region, followed by IDA's. On policy selectivity, the African Development Fund is the most selective for countries with good policies and institutions within its region, followed by the Asian Development Fund and IDA—which the research suggests are also well aligned with policy performance. Meanwhile, the performance-based allocations of the banks' concessional financial resources preclude substantial financial allocations to low-income countries under stress (LICUS), where the banks continue to engage through focused capacity building to help restore essential state functions and through social

FIGURE 6.3 Policy and poverty selectivity of aid from multilateral development banks, 2003



Sources: Dollar and Levin 2004; World Bank staff estimates.

service delivery to the most vulnerable groups, in some cases relying on trust fund support.

For middle-income countries the level of the banks' support is determined by institutional financial constraints, country creditworthiness considerations, and country demand factors. In recent years—especially in the context of the negative net transfer positions of the ADB, IDB, and World Bank—country demand has received much attention from the banks, reflecting “cost of doing business” concerns cited by developing country members as a factor discouraging them from borrowing from the banks for infrastructure and related investments,¹³ along with other constraints such as limited fiscal space. The banks are implementing broadly similar reforms to respond to these concerns, which are also being applied to low-income borrowers. Being developed under different names—the New Partnership Framework in the AfDB, New Lending Framework in the IDB, and Middle-Income Country Action Plan in the World Bank—these initiatives have involved a healthy rethinking of many bank processes, leading

them toward more risk-adjusted approaches that are also likely to enhance the efficiency of operations even as they contribute to country capacity building through the aforementioned increased attention to country systems.

ANALYTIC AND CAPACITY BUILDING SUPPORT

The multilateral development banks also contribute to country development through their analytic and capacity building support—both in terms of their inputs into the selection, design, and implementation of lending operations and in terms of the more fundamental challenge of helping countries manage their development efforts, regardless of the financing source. While the banks' analytic work is important for all developing member countries, it is relatively more important for the countries at the opposite ends of the performance spectrum, given the relatively smaller financial role played by the banks in those countries: for middle-income countries, targeted analytic support adds value that can catalyze private financing; for LICUS, more basic capacity building support is key. Future *Global Monitoring Reports* could usefully quantify the banks' contributions in the various areas of analytic and capacity building support. But this will require further work, including agreeing among the banks on appropriate metrics and monitoring tools.

Analytic work. Economic, technical, and sector work underpins the multilateral development banks' policy dialogue with member countries—on policies, strategies, lending, and capacity building support. In its 10-year retrospective on 70 World Bank country programs, the Bank's Operations Evaluation Department (OED) found that economic and sector work was critical for good outcomes, and that successful country programs were associated with timely analytic work.¹⁴ It also concluded that the absence of analytic work leads to unsatisfactory project outcomes, and

that such work can be an effective vehicle for engaging governments in policy dialogue and informing civil society. Though the review was focused on World Bank programs, its broad conclusions about the importance of analytic work are echoed in the evaluation reports of the other multilateral development banks.

- The AfDB's analytic work is being strengthened, building on the recommendations of an independent external evaluation, which emphasized the work's central importance to the Bank's policy dialogue, country strategies, and lending operations.¹⁵ To that end, the Bank has introduced the Country Governance Profile as a new diagnostic tool to systematically identify governance-related structural and institutional weaknesses and inform participatory dialogue. In 2004 such profiles were prepared for Benin, Cameroon, Chad, Malawi, Senegal, and Swaziland. The AfDB is also developing Private Sector Country Profiles, setting out its private sector strategies for member countries and building on investment climate assessments and other diagnostic work.
- Analytic work is the basis for all ADB policy discussions, strategy formulation, and preparation of lending and nonlending programs. Macroeconomic and poverty analyses and assessments on gender, governance, private sector development, the environment, and other areas provide the necessary background to formulate the Bank's country strategies, while detailed roadmaps steer operations in individual sectors. The ADB has carried out investment climate surveys in selected Asian countries, in partnership with the World Bank.
- The EBRD's analytic work is mostly conducted as part of project due diligence (for example, market studies and least cost analyses). To support its policy dialogue on the investment climate, the EBRD (together with the World Bank) has undertaken periodic Business Environment and

Enterprise Performance Surveys (BEEPS). The next round of BEEPS is planned for 2005, covering all 26 EBRD borrowers—and, as noted below, the survey is to be extended to all developing countries under a joint initiative of the multilateral development banks. A parallel EBRD-only exercise will focus on Early Transition Countries. The EBRD's knowledge transfer activities focus on market economy skills for the private and public sectors and on results-based demonstration projects.

- The IDB's country strategies benefit from analytic work carried out in partnership with governments and other development partners. Sector policy notes and, increasingly, debt sustainability assessments (in both HIPC and other countries) are becoming an integral part of the country strategy preparation process, albeit within a highly constrained administrative resource envelope—as reflected in the findings of the country program evaluations of the Bank's Office of Evaluation and Oversight (OVE), which has identified underinvestment in economic and sector work as a factor hindering the policy dialogue at the sectoral and country levels.¹⁶
- The World Bank has adopted a partnership approach to economic and sector work. Carrying out its analysis with borrowers helps promote capacity building while grounding the analysis in country conditions. Sharing the work with bilateral and multilateral partners helps contain costs by reducing duplication and promoting harmonization. Much of the Bank's diagnostic work on country fiduciary systems is carried out with partners, a trend also observed in the preparation of Poverty and Social Impact Assessments and Investment Climate Assessments. Growth in the Bank's economic and sector work has begun to level off from the rapid rates recorded several years ago when the Bank was overhauling its economic and sector work program. Sector work on human and social development and social protection, the rural sector and agricul-

ture, and other discretionary topics is gaining ground relative to fiduciary diagnostic studies as gaps in the latter have increasingly been filled. But the status of country fiduciary systems, assessments, and knowledge gaps will continue to require careful attention—especially given the capacity building role played by the multilateral development banks in helping countries implement the financial accountability systems needed to absorb higher aid levels.

Capacity building. Capacity building constitutes the quintessential challenge of development assistance, and support for it is embedded in almost all multilateral development bank activities. As discussed later in this chapter, support to build capacity in statistics and managing for results is central to the results agenda of the multilateral development banks. Of equal and complementary relevance to this report—given the recommendations of earlier chapters—is support for enhancing countries' absorptive capacity in managing and accounting for aid (and other resource) flows, in view of the need for increased volumes if the MDGs are to be met, improving capacity for private sector-led growth, and trade capacity building—particularly for trade facilitation, financial services, and transport infrastructure.

- *Aid management.* Increasing aid absorptive capacity requires credible country systems for accounting for and managing the money—including, importantly, fighting corruption. This involves arm's-length financial audits, competitive procurement, and accountable public expenditure management. All the multilateral development banks are working in these areas, with lessons learned shared through the Working Group on Governance, Anti-Corruption, and Capacity Building. Meanwhile, as part of the shift from enclave projects to SWAps, budget support operations, and broader lending support vehicles, the banks (and others, such as the U.K. Department for International Development, European

Commission, and IMF) have been helping to strengthen country systems for managing public funds from all sources, using diagnostic instruments such as Country Financial Accountability and Procurement Assessments, Public Expenditure Reviews, and HIPC Public Expenditure Management Assessment and Action Plans. All these efforts focus on the supply side of aid management and have generally received satisfactory marks in evaluation reviews. In a recent review of anticorruption activities, the World Bank's OED also stressed the importance of underpinning such efforts with demand-side initiatives—geared to fostering public support among a wide spectrum of stakeholders.¹⁷

- *Investment climate.* The multilateral development banks' approach to private sector development has evolved over time, from support for credit institutions to a greater focus on macroeconomic policies, and now to a greater focus on the quality of a country's investment climate. Institutions—including the “rules of the game”—and associated capacity building efforts are seen as key, and all the banks have major programs of support and analysis, including extensive investment climate surveys.¹⁸ As noted, the banks also recently announced their intention to extend the BEEPS currently used by the EBRD and World Bank in Europe to all developing countries, opening a new window into the conditions faced by the private sector in different country circumstances. Such country-specific information is especially valuable given multilateral development bank evaluation findings on investment climate assessments, highlighting the need for greater knowledge of country-specific constraints and opportunities. Going forward, the multilateral development banks need to ensure that this information—and that emerging from the investment climate assessments and Doing Business surveys—is fully reflected in the design and supervision of their country programs.

- *Trade facilitation.* The banks are active in facilitating trade, but more needs to be done, especially to coordinate better—avoiding duplication and gaps in country coverage and promoting synergies. The ADB has been supporting customs harmonization and streamlining and anti-money laundering and other measures, focusing on the Greater Mekong Subregion and Central Asia. The EBRD—using donor funds in conjunction with its Regional Trade Facilitation Programme—has been providing training and advisory services to help banks in countries such as Armenia, Azerbaijan, Georgia, and the Russian Federation improve their international trade finance services.¹⁹ The IDB provides direct loans and guarantees to local financial institutions to support their trade finance activities, including through its recently established Regional Trade Finance Facilitation Program, while its Multilateral Investment Fund supports the modernization of customs facilities and border crossings throughout Latin America and the Caribbean. Focusing on diagnostic work, in 2004 the World Bank carried out Trade and Transport Facilitation Audits in Benin, Chad, Guinea, Malawi, Mozambique, Rwanda, Tanzania, and Zambia—as part of an intensive program of support for Sub-Saharan Africa—as well as in Bangladesh, the Dominican Republic, and Tajikistan. It also approved 16 new projects with trade facilitation components, with commitment levels more than doubling over the previous year. Noting the marked shift in World Bank support from adjustment to trade facilitation during the 1990s, its OED has launched an evaluation of Bank assistance on trade; the findings should be available for next year's *Global Monitoring Report*.

Sectoral, Regional, Global, and Research Programs

The multilateral development banks' country focus is supported by four complementary activities, considered in turn below. First are

the banks' sectoral and thematic strategies and programs. Second are their regional programs—for addressing regional issues and regional public goods. Third are their global programs—for addressing global issues and global public goods. Fourth is their research, itself an international public good.

SECTORAL AND THEMATIC STRATEGIES, PROGRAMS, AND OUTCOMES

As the banks have become increasingly country focused, they have relied on sectoral and thematic strategies to guide country strategy formulation, program and project design, and implementation, building on the lessons of operational experience and research. These strategies set out the banks' sectoral and thematic modalities for helping developing member countries achieve their objectives. Of course, to fully understand the banks' different sectoral and thematic orientations, the evidentiary picture needs to go beyond statements of strategies and intentions. It must also include analysis of actual interventions, assessing how underlying sectoral and thematic strategies have been reflected in country strategies and programs—as well as in the banks' sectoral and thematic “results,” once their interventions have worked their way through country systems.

Neither of these other dimensions is easy to address across the multilateral development banks with current data. What is sketched below is the very beginning of an analysis that could in due course be linked more directly to the results measurement initiatives being developed by the banks in other contexts. Taking it further in future *Global Monitoring Reports* will require more in-depth work, including investment by the banks in harmonizing their sectoral and thematic classifications for lending and analytic work.

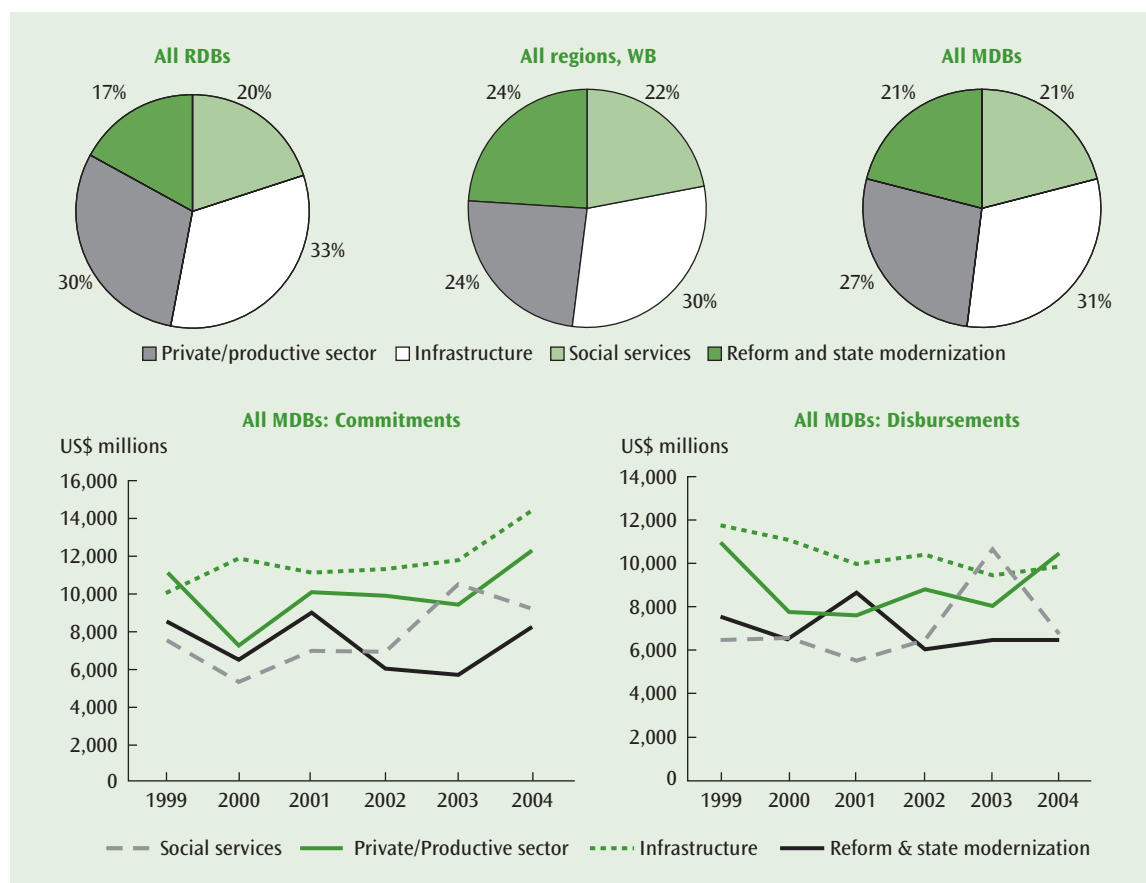
Strategies. In line with the themes of this report, all the banks' strategies stress the importance of private sector-led growth, infrastructure, governance, and—with the exception of the EBRD—delivery of social services. Specifics include:

- The AfDB's sectoral policies and strategies cover agriculture and rural development, the social sectors (especially education and health), fighting HIV/AIDS, integrated water resources management, water and sanitation, infrastructure, private sector development, gender and the environment, governance, finance, and regional economic cooperation and integration.
- The ADB's sectoral and thematic policies and strategies set out the Bank's institutional priorities, directions, and guidance to staff, including for safeguards and gender, which were updated last year. At that time the Bank also reviewed its overarching poverty reduction strategy—assessing progress, evaluating the conceptual framework, and addressing implementation challenges—and enhanced its country focus through alignment with national PRSs, introducing capacity development as a new thematic priority and integrating timebound indicators in all operations.
- The EBRD's sector strategies cover its main activity areas—agribusiness, energy, financial sector, microfinance and small and medium-size enterprises, municipal infrastructure, property and tourism, transport, and telecommunications—setting out the approaches that must be followed in its operations.
- The IDB's “2+4+1” program focuses on seven sector strategies developed in 2002–3 in the priority areas of the Bank's institutional strategy.²⁰ The seven strategies cover sustainable economic growth, poverty reduction and promotion of social equity, modernization of the state, competitiveness, social development, regional integration, and the environment. In addition, there is an implementation plan for the strategies, including a series of output indicators, designed to help focus Bank actions and enhance their development impact.
- Among the World Bank's many sector strategies, the most relevant for this report are those that focus on private sector-led growth in manufacturing, agriculture, and services, for which the Bank Group—

drawing on the synergies across the Bank, International Finance Corporation (IFC), and Multilateral Investment Guarantee Agency (MIGA)—can provide full-service support; infrastructure, through the Bank Group Infrastructure Action Plan, which seeks to revitalize this critical sector by internalizing recent innovations involving pragmatic approaches, output-based aid, public-private partnerships, and so on; governance, where the focus is on institutional development through sustained reform, effective public financial management, transparent processes, and anticorruption efforts; and the delivery of social services, especially for primary education and health care.

Lending shares and trends. Sectoral lending shares across the multilateral development banks are summarized in figure 6.4. Measured by disbursements over the 1999–2004 period, infrastructure is the largest sector for the multilateral development banks as a group. It is also the largest sector for the ADB and IDB individually, and for the World Bank overall and in East Asia, South Asia, and Europe and Central Asia. For African and Latin American and Caribbean borrowers from the World Bank, social sector lending is the largest. While new commitments for infrastructure have been increasing, disbursements have been declining—reflecting the lagged effect of developments in the 1990s, when infrastructure commitments fell because of concerns about

FIGURE 6.4 Big 5 multilateral development banks: sectoral distribution of lending, 1999–2004



Source: Staff of the Big 5 multilateral development banks.

Note: Data are for calendar years. Sectoral classification of MDB operations is not fully comparable across the institutions, indicating the need for better harmonization of the classification systems to provide a firmer basis for comparison and analysis.

environmental risks, fiscal space, and crowding out of the private sector, which was expected to play a larger role than materialized. With infrastructure commitments on a recovery path, disbursements will also recover, albeit with a lag.

Regional differences in bank support warrant further analysis—especially between Asia (where ADB and World Bank sectoral shares are similar) and Latin America and the Caribbean (where IDB and World Bank sectoral shares are different). Further analysis is also warranted of the different approaches taken by the banks to lending support for state reform and modernization, which constitutes a much larger share of disbursements by the World Bank than by the regional development banks. Such analyses could be undertaken for the next *Global Monitoring Report*, including trends in banks' analytic work across sectors and countries.

Results and evaluations. The methodological challenges of going beyond lending tallies to assess the multilateral development banks' sectoral contributions and results are not insignificant, involving complex methodological issues on causation and attribution. Adopting a pragmatic approach, the banks are beginning to measure their sectoral outputs more systematically—for example in the context of the IDA14 Results Measurement System (discussed later in this chapter). But it is still early in this process, and much work needs to be done to see how to move credibly from measuring bank-supported sectoral outputs to outcomes.

Whatever solution ultimately emerges, it is likely to rely heavily on the findings of the banks' independent evaluation departments, which have carried out a number of relevant reviews. These generally paint a mixed picture, in which the banks are found to have made contributions in infrastructure, private sector development, governance, and the social sectors, but where performance could have been better—especially at it has affected country, program, and project outcomes, institutional development, and sustainability. While individual findings vary, three themes run through many of the banks' sectoral and thematic evaluations:

- The need for clearer evaluability at the design stage, with the intended results and measurement platform (including indicators and baselines) clearly set out along with the instruments and modalities of implementation.
- The importance of analyzing the political economy of reform—and the incentives of key players in sector reform—to allow the strategies to take those factors into account and be more likely to lead to sustained implementation at the country level.
- The importance of providing country typologies for guiding localization, so that the strategies can be more easily customized to country conditions.

REGIONAL PUBLIC GOODS AND PROGRAMS

The multilateral development banks support a number of regional and subregional programs and initiatives in collaboration with other partners, as highlighted below. Especially important for the regional banks, given their regional mandates, these programs are a mix of regional public goods programs, including for regional infrastructure projects, and multicountry programs.

- Regional cooperation and integration are key areas for the AfDB, including transboundary water rights and river basin development. Support has been provided for capacity building for regional economic communities, development of regional infrastructure, creation of an enabling regional environment for the private sector, promotion of sustainable development at the regional level, and the fight against HIV/AIDS. The AfDB supports the NEPAD Secretariat, the African Union, the Global Environment Facility (especially on the development of the Environmental Action Plan for Africa), and the Africa Regional Coordination Unit for the UN Convention to Combat Desertification.
- In Asia the Greater Mekong Subregion Program has long been a prominent area of ADB support, promoting cross-country

cooperation in a number of sectors through investments in infrastructure, policy initiatives, and institutional mechanisms.²¹ Other regional programs cover the Pacific Islands, Central Asian regional economic cooperation, South Asian subregional economic cooperation, the Indonesia, Malaysia, and Thailand growth triangle, and the Brunei, Indonesia, Malaysia, Philippines growth area. The Asian Development Bank also implements technical assistance projects and loans supporting regional cooperation. Areas of support range from infrastructure (transport, energy, trade facilitation) to health (combating infectious diseases), environment, urban development, financial and capital market development, and capacity building in public sector management, including managing for development results. Particularly noteworthy is the collaboration between the ADB and IDB on regional public goods—including their joint sponsorship of the recent Tokyo Forum on the Operational Dimensions of Supplying Regional Public Goods through Regional Development Assistance—and ADB leadership on tsunami-related work, including the recent high-level conference it organized²² and its pledged support for an interim tsunami warning system.

- The EBRD administers a number of regional programs supporting private sector development, including for trade facilitation and small and medium-size enterprise development. These programs include a series of country-specific subprojects, which are monitored and processed as country-level operations. In addition, a growing number of projects cover more than one country (for example, regional equity funds, projects in which sponsors from one country invest in another, and energy trade).
- The IDB's approach to regional issues has long focused on facilitating cross-fertilization on policy issues. Its Regional

Policy Dialogue provides a forum for policymakers to discuss issues of common concern in its seven network areas (education, natural disasters, environment, central banks and finance ministries, poverty and social protection, public policy management, and transparency), with 15 regional and subregional meetings in 2004. Its Regional Technical Cooperation Program has focused on promoting modernization of the state, supporting the private sector through competitiveness strengthening, and addressing social issues of development. Finally, responding to the growing demand for regional public goods over the past decade to support country reform efforts, the IDB's Initiative for the Promotion of Regional Public Goods is now operational. Since its approval in March 2004, it has received 35 proposals for an amount close to \$64 million. The initiative will provide up to \$10 million annually to help finance selected projects.

- The World Bank supports a large number of regional programs and initiatives, in cooperation with the other multilateral development banks and relevant partners. Examples of direct relevance to the priorities set out in earlier chapters include the Trade and Transport Facilitation in Southeast Europe Program, which promotes more efficient and less costly trade flows and provides customs standards compatible with the European Union; the Latin American regional initiative on infrastructure, in cooperation with the IDB; and the strategic framework for IDA assistance to Africa in cooperation with the AfDB and other partners (box 6.4).

GLOBAL PUBLIC GOODS AND PROGRAMS

Like their regional programs, multilateral development banks' global programs are a mix of global public goods programs and multicountry programs. As implementing

BOX 6.4 IDA's strategy in Sub-Saharan Africa

Strategic context and vision

The International Development Association (IDA) is the World Bank's main source of development assistance for the world's 81 poorest countries, including 39 in Sub-Saharan Africa. This year's international focus on Africa offers unique opportunities—and challenges—for IDA to support African development. In February 2005 donor countries reached a milestone agreement to replenish IDA over the next three years with the largest expansion in two decades—at least 25 percent, to \$33 billion—with about half of IDA resources going to Africa. This increase represents a major step in international efforts to promote stronger, broadly based economic growth in order to fight poverty and achieve the MDGs. Among other things, the funds will be used to improve access by poor communities to clean water, better communications, and power; support private sector development and a better investment climate to promote faster growth; provide grants to alleviate severe debt problems in Sub-Saharan Africa and elsewhere; promote transparent assessments of country performance on economic policies, governance, and poverty reduction efforts; better coordinate donor support for these efforts; and fund an innovative monitoring system of development results. In addition to IDA, Africa's performance can be enhanced by positive outcomes in other forums, especially the Doha Round of international trade negotiations and meetings on the quality and quantity of donor funding, as discussed in earlier chapters.

Against this background, IDA's outlook for Africa is one of hopeful realism. Hopeful because:

- The New Partnership for Africa's Development (NEPAD) and the African Union are leading more actively in the areas of postconflict recovery, economic management, public accountability, and governance, and promoting regional integration within countries: Ghana, Nigeria, Senegal, South Africa, and others are shaping their economic agendas and taking ownership of their development.
- Macroeconomic management is improving, as are country policies and institutions.
- Growth is widening, with 15 countries having maintained growth rates of more than 5 percent for several years.
- Subregional integration efforts are growing.
- HIV/AIDS prevention is beginning to show promise.
- The Extractive Industries Transparency Initiative is taking root.

But realism is needed as well, because:

- 7 percent growth is needed to achieve the poverty reduction MDG.
- Conflict remains a threat to stability, investment, and growth.
- HIV/AIDS and malaria are exacting enormous costs in terms of lives, public services, productivity, and growth.
- Aid remains insufficient in terms of both quantity and quality (with weak harmonization and alignment).

Strategic directions

The new emphasis in the IDA strategy is to accelerate and deepen shared growth to achieve sustained poverty reduction and make faster progress toward the other MDGs, and to increase investment in the assets (human, physical, financial) of poor people to enable them to participate in and benefit from growth. An action plan is being developed to scale up World Bank activities in the context of Commission for Africa, IDA14, and other international efforts. Elements will include:

- *Trade and regional integration*—focusing on a trade policy agenda that promotes an export push in agriculture (particularly for commodities with strong processing linkages).
- *Agriculture and rural development*—developing a multisectoral approach explicitly linked to IDA's private sector development and infrastructure programs.
- *Private sector and infrastructure*—concentrating on reducing the transaction costs of doing business in Africa. The region will have a combined strategy with the International Finance Corpo-

ration (IFC) and the Multilateral Investment Guarantee Agency (MIGA) to help fill the gaps in infrastructure. Regional projects, concessions, and privatization operations will increase.

- *Alignment and partnership*—aligning World Bank support consistently with government-led programs and processes as well as with other donors.
- *Governance, capacity building, and conflict*—addressing key dimensions: on governance, clearer benchmarks will be set for measuring performance in difficult environments, drawing on the work of the UN Economic Commission for Africa; on capacity building, a task force is developing innovations in these areas; and on conflict, Bankwide experiences and lessons point to the value of explicit attention to conflict prevention and, in postconflict cases, the need to be engaged early and deeply.
- *Investing in people*—focusing on three strategic areas: strengthening frameworks and delivery systems to accelerate progress toward the MDGs; helping to develop integrated macro-micro systems for social protection and risk mitigation; and emphasizing selected areas of strategic leadership and advocacy, including for infectious diseases (especially HIV/AIDS and malaria) and the education MDGs.

Source: World Bank staff.

agencies geared to supporting country development, all the banks are involved in helping their clients meet their commitments under international agreements governing the provision of global public goods—from peace and security to disease control and support for the global commons to financial stability and anti-money laundering, open trade, and knowledge sharing. They are implementing agencies for the Global Environment Facility and participate in the Global Fund to Fight AIDS, Tuberculosis, and Malaria, the Global Alliance for Vaccination and Immunization, and so on.

As the single global institution among the banks, the World Bank's support for global programs has grown rapidly in recent years, with 70 different programs funded by the Bank's core budget, the Development Grant Facility, and donor-supported trust funds. World Bank support for global programs has been the subject of an extensive evaluation by its OED. The *Global Monitoring Report 2004* reported on the findings of the OED phase 1 report.²³ As noted there, OED concluded that the Bank had played a useful role in these programs by providing a platform for learning, advocacy, and collaborative action to

address key global challenges. But it generally found the programs to be undermanaged. The phase 2 report finds a lack of results orientation, focus on advocacy without the necessary resources for technical assistance or investments, unclear poverty impacts, and weak knowledge management.²⁴ OED's recommendations stress the need for a global strategy, based on a consultative process involving key partners, and better day-to-day management of the existing global portfolio, designed to enhance returns to Bank country operations and help set international standards for quality. In line with these recommendations, the Bank has established a small, central Global Programs and Partnerships Secretariat to better manage and monitor these activities and is currently fleshing out its strategy.

RESEARCH

Research by multilateral development banks has helped to articulate the global and regional development agenda, with notable contributions on aid, private sector-led growth, and trade, as reflected in earlier chapters of this report. It has also provided a basis for the application of emerging lessons at the

country level, albeit somewhat less successfully according to the banks' evaluation reviews, which have generally pointed to the need for greater specificity based on country conditions. OED, for example, has argued that the World Bank's research on the investment climate provides insufficient guidance to client governments and staff.²⁵

Meanwhile, consistent with the partnership theme of this chapter, another area identified for improvement involves cross-fertilization across the multilateral development banks. At present, the banks' researchers meet in a variety of contexts, but more systematic approaches would also be fruitful, especially given the banks' different vantage points—with the regional banks often intermediating between the global development agenda and regional considerations. The AfDB and ADB are currently reviewing the roles and contributions of their research capacities; it would be useful to broaden these initiatives to the other banks, and more generally to increase interactions across the banks in this area.

- The AfDB has launched efforts to upgrade its research capacity—in tandem with the strengthening of its economic and sector work discussed above. These efforts are focusing on poverty analysis, growth, and debt sustainability; macroeconomics and forecasting; public policy and public sector management; agriculture and food security; financial sector development; science, technology, and industrial development; human capital and social development; and international trade and regional integration.
- The ADB undertakes research, including innovative, experimental, or theoretical work to acquire new knowledge, normally directed toward a specific purpose such as developing a new policy or evaluating a program. The bank's intellectual work includes advocacy, capacity building, and research, with each of these roles contributing in different ways to development think-

ing and knowledge. In 2004 the ADB adopted a knowledge management framework to enhance knowledge sharing among its clients and to become a better learning organization. As noted, the Bank is currently carrying out a detailed review of its research function, including analysis of cost, user demand, and quality, with a view to enhancing quality and impact.

- Flagship EBRD research publications are the *Transition Report* (autumn) and *Transition Report Update* (spring), which include indicators on progress in transition at the country level, as well as topical analyses. Areas of particular research interest include transition economics, social transition, the business environment, energy, infrastructure, and the financial sector. The Office of the Chief Economist, which oversees EBRD research, provides the transition impact ratings for projects, which are a key input for assessing operational performance.
- Mainstays of IDB research are a focus on macroeconomics, the private sector, and growth; trade and integration; and sector strategies and policies. The bank has also been active in supporting regional research networks promoting academic research and policy dialogue and in strengthening the research capacity of regional institutes.
- Research is central to the World Bank's "knowledge bank" mission, with its agenda evolving in response to operational and policy needs. Its main focus is strategic, and directed at informing the overall agenda for development policy and assistance, through flagship vehicles such as this year's *World Development Report* on the investment climate and analysis and data critical to international trade negotiations—as in Cancun, Mexico, last year—and the ongoing international dialogue on growth, poverty reduction, trade, and aid effectiveness, especially with respect to the mutual contributions of developing and developed countries, as discussed in earlier chapters.

Partnerships and Harmonization

Virtually everything discussed in this report involves partnerships—at the regional and global levels, at the country level, and at the institutional level—all touching the issue of harmonization in one way or another. Also relevant are the issues of transparency and disclosure, which bear on the inclusiveness or exclusiveness of the partnerships under consideration.

GLOBAL PARTNERSHIPS

The multilateral development banks actively participated in the recent Paris High Level Forum on Harmonization, Alignment, and Results, with the heads of the banks endorsing the Paris Declaration on Aid Effectiveness—setting out specific commitments for further alignment, harmonization, and results.²⁶ All engaged in the Working Party on Aid Effectiveness and Donor Practices, a broad partnership of bilateral and multilateral donors and agencies and representatives of more than 16 developing countries, supported by the OECD's Development Assistance Committee (DAC). The working party was put in place after the 2003 Rome High Level Forum on Harmonization to facilitate, support, and monitor progress on harmonization, alignment, and managing for development results. The ADB is represented on the working party's steering committee, and multilateral development bank staff chair or co-chair four of the five subgroups, and contribute substantively to the work of all. The World Bank chaired the steering committee for the Paris forum and has seconded a full-time staff member to the DAC Secretariat to assist the working party. In preparing for the forum, all the multilateral development banks were involved in regional workshops organized to ensure the inclusion of country and regional perspectives on the challenge of harmonization and managing for results.

Central to these efforts is the banks' work in fostering a Global Partnership on Managing for Development Results. To that end, they have established an active working

group, and along with bilateral donors and the United Nations Development Programme (UNDP) have formed the Joint Venture on Managing for Development Results, under the Working Party on Aid Effectiveness and Donor Practices. The aims are to harmonize donor requirements for country results reporting around national systems and better coordinate donor support for helping countries strengthen their capacity to manage for results. The main outcome of the global partnership to date is the convergence of the multilateral development banks around agreed core principles and results agendas that share common elements and approaches—as discussed below and as reflected in the recently issued (draft) *Results Sourcebook*.²⁷ Building on these efforts and the pre-forum regional workshops, in Paris the banks committed to support regional communities of practice in managing for development results, including through a focused learning process in selected developing countries.

COUNTRY-LEVEL PARTNERSHIPS

The true test of global partnerships is operational work at the local level: Without follow-through there, the various global meetings remain talk shops with little impact. At this level, the multilateral development banks have entered into a variety of arrangements with their developing member countries and other partners—ranging from preparation of joint analytic work and strategies to joint operations and common environmental impact assessment procedures. These processes have been facilitated by the common direction in which the banks have been moving on their strategies and lending, as summarized earlier in tables 6.1 and 6.2. Nevertheless, individual personalities and behavior continue to affect the speed and depth of progress on institutional commitments to partnership. Hence while there are many examples of good practice, there remain instances of bad practice, which are long remembered by those affected. Despite the sense among many that World Bank culture has changed, its staff continues to be

considered arrogant by some, including staff of other multilateral development banks, and as reflected more broadly in the World Bank Global Poll.²⁸

Country strategies and portfolio reviews. As examples of good practice, multilateral development banks are increasingly coordinating their country strategies and portfolio reviews with each other and with other partners. Coordinated strategies are planned, under preparation, or were recently completed for Bangladesh, Cambodia (box 6.5), Honduras, Nigeria, Tanzania, and Uganda; these exercises involve working with the authorities to ease administrative burdens and with other partners to coordinate schedules, share diagnostics, and ensure consistency and balance while avoiding

contradiction and duplication. In LICUS, such as Afghanistan, Guinea-Bissau, Haiti, Liberia, Sudan, and Timor Leste, multilateral development bank teams are collaborating closely with other donors to provide support on strategy development (including, in some cases, transitional results matrixes and pooled funding mechanisms). Meanwhile, the AfDB, ADB, and World Bank have undertaken joint portfolio reviews in a number of countries, including Kenya, the Kyrgyz Republic, Mozambique, Rwanda, the Philippines, Uganda, and Vietnam.

Operational support. The innovations in multilateral development banks' lending instruments discussed earlier in this chapter have opened the door to much greater partnership at the country level, especially the

BOX 6.5 Cambodia's country strategies—coordinating efforts among multiple donors

The Cambodian country strategies for the ADB, U.K. Department for International Development (DFID), and World Bank were prepared together, all drawing on the country's poverty reduction strategy. By working together, the partners aimed to increase coordination and coherence in the policy dialogue and reduce government transaction costs in dealing with them. Meanwhile, the government has signaled a greater commitment to country ownership and leadership of the development and donor coordination process, giving greater attention to project implementation and to enhancement of the level of resource transfers from development partners.

In support of the above, the ADB, DFID, and World Bank have agreed on a "lead agency" approach to implementing their partnership. Under this approach the lead agency in a sector (or sectors) provides primary support for the government's strategy development and implementation, while providing backup support in other sectors. For example, the ADB has taken the lead in agriculture and water resources, education, finance, and transportation, while supporting the dialogue in sectors where the DFID or World Bank has the lead role.

The three donors have also developed a set of principles guiding their relationships with each other and with the government, other international development partners, the private sector, and civil society. Other partnership initiatives include restructuring government-donor technical working groups at the sector and thematic levels, greater reliance on SWAs, and better harmonization of donor procedures in project implementation.

The ADB, DFID, and World Bank have cooperated with the government (and with other donors) on the preparation of the Cambodia National Action Plan on Harmonization and Alignment, which adopts a LICUS approach by placing the burden on donors for initial efforts to reduce transaction costs and improve information and reporting, rather than waiting for government capacity to improve before improving donor behavior.

Source: ADB and World Bank staff.

introduction of SWAp by the AfDB, ADB, IDB, and World Bank.²⁹ (See box 6.6 for an example of a SWAp in support of HIV/AIDS prevention and treatment.) The World Bank's Poverty Reduction Strategy Credits (PRSCs) are also proving useful for coordinating donor support for low-income countries' poverty reduction strategies, with half of the PRSCs currently under implementation involving coordination of support and conditionality with other donors.

Joint analytic work. Carrying out joint analytic and diagnostic work is a win-win approach to reducing costs for donors and countries alike. The multilateral development banks have increasingly conducted analytic work with other partners, especially for the core diagnostic and fiduciary reviews that underpin lending. To facilitate sharing and

promote collaboration on analytic work, the World Bank hosts the Country Analytic Work Web site (www.countryanalyticwork.net), which offers major reports from more than 25 multilateral and bilateral donor agencies; more than 1,400 reports were added to the site in 2004.³⁰ It will be important to build on this initiative by using the database for joint programming of analytic and capacity building work, based on identification of gaps and needs in key areas.

PARTNERSHIPS AMONG INTERNATIONAL FINANCIAL INSTITUTIONS

As noted at the start of this chapter, the business models of international financial institutions differ between the multilateral development banks on the one hand and the IMF on the other. These differences translate into differently shaped partnerships across the

BOX 6.6 Malawi's sectorwide—and multisectoral—approach to HIV/AIDS

Partly because of work on its poverty reduction strategy (PRS), donor coordination in Malawi is improving. Major donors and sectoral donor working groups in economic management, poverty reduction, water, and agriculture meet regularly. In addition, donors have been collaborating on sectorwide approaches (SWAp) for development assistance—as evidenced by the Multisectoral HIV/AIDS Project, which supports Malawi's efforts to reduce HIV transmission, improve the quality of life of those infected and affected by HIV/AIDS, and mitigate the disease's impact, all central PRS objectives.

Key project components include a focus on advocacy aimed at changing behavior and preventing HIV transmission, especially among target populations, such as by promoting safer sex and incorporating life skills education and HIV/AIDS information into education curriculums. The project also focuses on impact mitigation, targeting those infected and affected by the epidemic. Other components are designed to support the work of the National AIDS Commission in preventing and treating the epidemic, monitoring and evaluating developments, coordinating support for policy-related issues, and managing procurement, financial accountability, and institutional development.

The project is structured as a SWAp and is supported or under consideration for support by a number of donors, including the African Development Fund, IDA, Canadian International Development Agency, U.K. Department for International Development, Global Fund to Fight AIDS, Tuberculosis, and Malaria, Norwegian Agency for International Development, United Nations Development Programme, and U.S. Agency for International Development. It involves coordinated joint implementation reviews, pooled funding arrangements, a single framework for financial reporting, monitoring, and evaluation (including one set of quarterly financial tables and progress reports for all eight donors), and harmonized procurement.

Source: AfDB and World Bank staff.

institutions. Among the banks, given their many parallel concerns and challenges, there is a premium on cross-fertilization and networking in the pursuit of good practices that can be adapted to different regional and country circumstances. Between the banks (especially the World Bank) and the IMF, given their more complementary roles and contributions, the focus is more on joint products and an appropriate division of labor in producing them.

Multilateral development bank networks.

Consistent with the above, the multilateral development banks are increasingly functioning as a federation of networks, operating at almost as many different levels as the banks themselves operate. The recent announcement that the banks will extend the EBRD–World Bank Business Environment and Enterprise Performance Surveys (BEEPS) to other regions is but the latest development in an ever expanding series of such efforts. Another recent example is the January 2005 meeting hosted by the ADB to discuss common challenges in managing the performance-based allocation systems of the banks' concessional windows—an exercise that is likely to segue into an ongoing working group, especially as the banks move toward disclosure of country policy and institutional assessments in early 2006.

Meanwhile, working groups on financial management, procurement, the environment, and capacity building have continued to progress, with new groups such as the Working Group on Managing for Development Results energizing bank partnerships across a broad front. These groups have been productive forums for sharing experiences, challenges, and best practices across the institutions. Going forward, they should be encouraged to think more boldly and strategically, moving beyond the harmonization agenda to seeing how they might function as full-fledged networks across the banks. They also should be encouraged to advise on future directions for strategic selectivity, which could constitute a major theme of the analysis of the multilateral development banks in

next year's *Global Monitoring Report*, including the division of labor in country, regional, and global programs, building on the banks' respective mandates and areas of comparative advantage.

World Bank–IMF collaboration. In line with the earlier discussion and as highlighted below in the section on IMF partnerships, three issues continue to be of central importance to the World Bank's partnership with the IMF (and of continuing interest to the other banks as well): debt sustainability, the PRS process, and streamlining of structural conditionality. In addition, two other themes warrant highlighting in line with the themes of this report: collaboration between the Bank's OED and the IMF's Independent Evaluation Office (IEO), and issues surrounding public investment in infrastructure. On the partnership between OED and IEO, the collaborative review of the PRS process referred to earlier set an important precedent and example for future reviews, including by other institutions.³¹ On infrastructure investment, the Bank and the IMF are working on steps to safeguard productive public investment and improve public investment planning and oversight, while maintaining a focus on fiscal and macroeconomic sustainability. Following up on work by the IMF's Fiscal Affairs Department—carried out in close cooperation with the Bank and the other multilateral development banks, particularly the IDB—eight case studies have been prepared, the preliminary findings of which point to little impact on growth of the public investment compression under investigation.³² (See also below, where this topic is discussed in the context of the IMF's role and work.)

PARTNERSHIPS WITH CIVIL SOCIETY

All the above partnerships are among “insiders”—those with institutional affiliations that give them access to information. But for many critics of international financial institutions, the more relevant issue is openness to “outsiders”—those without

official affiliations and credentials, for whom access to information and transparency of the institutions' activities are key. Over the past 15 years the multilateral development banks have adopted formal policies for partnering with civil society and for providing more open access to information and documents, with a number of further changes recently approved (by the World Bank) or pending or under consideration (by the AfDB and ADB). (See table 6.3 for the current disclosure status of key classes of documents as authorized by the banks' Boards of Directors.) Nevertheless, there remain concerns that the banks have not met a standard of transparency and accountability commensurate with their power and influence in a number of areas, but especially on project implementation and Board deliberations.

Managing for and Measuring Results

This section addresses two points. First, what are multilateral development banks doing to manage better for results? Second, what are they (and others) doing to measure results?

MANAGING FOR RESULTS

The conceptual framework for multilateral development banks defines results as sustained improvements in development outcomes at the country level. It posits that outcomes can be improved through critical actions along the results chain that leads from inputs to outputs and in turn to outcomes. For the banks this translates into a focus on country capacity and “demand” for results, and on bank strategies and quality. All the banks have approached the results agenda in a similar manner, providing similar kinds of support to client countries (table 6.4). The exception is the EBRD, which does not have a program supporting statistical capacity building.

Country pillar. All the banks stress that the most important element of the results agenda is the support provided for country-

based systems. The key elements of the country pillar are support for public sector management and statistical capacity building. This support has two objectives. First, it aims at increasing the efficiency of country resource allocation and use—whether at the national, state, provincial, or local level, or in a given sector (or both). Second, and more narrowly, it aims at improving implementation of bank-financed operations, through greater reliance on country systems for managing for results.

Helping countries manage for results is at the heart of the banks' public sector management agenda. More specifically, such efforts call for greater attention to certain aspects, such as building evaluation capacity and developing other vehicles to increase accountability in government agencies and departments (box 6.7). This process is occurring in all the banks, whether in the context of training staff from project executing agencies (as in the AfDB and IDB), using technical assistance grants to build evaluation capacity in borrowing countries (ADB), building evaluation capacity in project agencies on a project-by-project basis (EBRD), or strengthening country budget and evaluation systems in the context of policy-based lending (World Bank). The World Bank, with its partners in the Public Expenditure and Financial Accountability (PEFA) program,³³ has developed standardized performance indicators for use in monitoring country progress in public financial management, and is widely consulting with development partners (through the OECD's Development Assistance Committee) and client countries. The indicators are part of a strengthened approach to public finance reform that emphasizes country leadership in developing the reform strategy, donor coordination behind the government strategy, and performance indicators for monitoring progress over time.

Supporting and complementing these efforts is a major agenda to help countries build their statistical capacity. Without good statistics, governments cannot deliver efficient

TABLE 6.3 Transparency among multilateral development banks

Type of information/stage of development	AfDB	ADB	EBRD	IDB	World Bank
Country strategy documents					
Early draft	Yes	Not routinely; proposed in new policy	Yes	No	Yes
Final draft (pre-Board)	Under consideration	No	No	No	No
Final (after Board)	Yes	Yes	Yes	Yes	Yes
Analytic and project work					
Economic and sector work	Yes	Not routinely; proposed in new policy	Partially	Yes	Yes
Country policy and institutional assessments (2005 scores)	Under consideration	Yes	Yes (Transition Scores in <i>Transition Report</i>)	No	Yes
Appraisal reports (excl. privileged information)	Yes	For public sector projects, yes; for private sector projects, no. Yes for both proposed in new policy	Partially (such as Environmental Impact Assessments)	Yes	Yes
Project supervision reports	No	No; updated Project Performance Reports disclosed in proposed new policy	No	No	No
Project completion reports (excl. privileged information)	Yes	For public sector projects, yes; for private sector projects, no. Yes for both proposed in new policy	No	Yes	Yes
Policy papers					
Final draft (pre-Board)	Under consideration	No	No	No	No
Evaluation documents					
Bankwide	Yes	Yes	Yes	Yes	Yes
Country strategies	Yes	Yes	No (country strategy evaluations still in pilot stage)	Yes	Yes
Sector reviews	Yes	Yes	Yes	Yes	Yes
Project audits	Yes	Yes	Partially (through summary documents)	Yes	Yes
Board procedures					
Agendas	Yes	No; proposed in new policy	No	Yes	Yes
Minutes	No; but summaries of Board discussions, yes	No; proposed in new policy	No	Yes	Yes

Source: Staff of the Big 5 multilateral development banks.

TABLE 6.4 Managing for development results in multilateral development banks

Type of support	AfDB	ADB	EBRD	IDB	World Bank
Country pillar					
Public sector management	√	√	√	√	√
Statistical capacity building	√	√	No	√	√
Institutional pillar					
Strategies	√	√	√	√	√
Projects	√	√	√	√	√

Source: Staff of the Big 5 multilateral development banks.

BOX 6.7 Multilateral development banks' support to build Colombia's culture of evaluation

In 2000, with support from the IDB and World Bank, Colombia implemented three emergency social programs to help poor people cope with the economic crisis—Familias en Accion, Empleo en Accion, and Jovenes en Accion, collectively known as the RAS (Red de Apoyo Social). Familias is a cash transfer program conditional on school and health center attendance by children; Empleo is an employment program for low-skilled adults. And Jovenes is a job training and subsidy program for young people from poor neighborhoods. Of the combined \$400 million in loans for the programs, \$5 million was programmed to be spent on external evaluations.

Highly credible because of their high quality, the evaluations found that the programs are effective tools for crisis management at the household level. For example, the evaluation of Familias en Accion showed that food consumption was 14–24 percent higher among recipients, with no effect on household tobacco and alcohol consumption; school attendance rates were 4–8 percentage points higher among program participants age 12–17; and program participants age 0–6 were taller (by an average of 0.75 centimeter) and heavier (by 0.25–0.50 kilograms) than nonparticipants—partly due to less illness among these children, particularly in rural areas.

The evaluations also played an important strategic role. Critics of the Familias program had argued that it was costly and that its grant money would be poorly spent by beneficiary families, making it a candidate for budget cuts. When the evaluation results were presented to the president, the government's strategy reversed: the program was not only maintained, but pilots and evaluations were conducted to explore the possibility of expansion.

The RAS evaluations also helped institutionalize a culture of evaluation and results-based management in Colombia's social sectors. While the government had established an evaluation department, the National System for Evaluation of Results and Public Management (SINERGIA, based on its Spanish name), in the early 1990s, the RAS evaluations gave it a concrete objective. The IDB and World Bank worked with SINERGIA to develop its capacity to be a good “consumer” of external evaluations and to undertake evaluation studies of its own. In recent years technical assistance, grants, policy-based loans, and investment operations have supported SINERGIA's evaluations of social programs, preparation of legislation requiring periodic impact evaluations of social programs, creation of a multimministerial group on impact evaluation, regular production and dissemination of reports monitoring government progress in implementing policies, and a high-profile international conference on the importance of impact evaluations to government policy.

Source: Inter-American Bank and World Bank staff.

administration, good management, and evidence-based policymaking. Nor can citizens effectively monitor government performance and make informed decisions about their lives. Thus an effective and efficient national statistical system, providing the data needed to support better policies and monitor progress, is a crucial component of good governance and accountability. Support for capacity building in this area complements multilateral development bank support for public sector management in other areas, such as budget management and auditing, and is being provided by all the banks except the EBRD, as noted earlier. Programs include technical assistance grants for statistical capacity development such as those provided by the ADB. In addition, a number of joint initiatives, many working closely with the PARIS21 initiative, are under way.³⁴ These include the IDB, United Nations Economic Commission for Latin America (ECLAC), and World Bank Program for the Improvement of Surveys and the Measurement of Living Conditions (MECOVI), which provides technical and financial assistance to improve household surveys of social conditions; the AfDB's work with the International Comparison Programme in helping countries collect economic statistics; and the World Bank's Stat-cap program, which provides support for the long-term development of national statistical systems and may involve a series of grants or loans as appropriate.

Institutional pillar. Efforts to bolster multilateral development banks' performance and results focus on country strategies and lending operations—including support for measures to help countries develop their own capacity to manage for results, as described above—with independent and self-evaluations playing a key role.

As noted earlier, the AfDB, ADB, and World Bank are piloting results-based approaches (see table 6.1). The EBRD and IDB are incorporating many features of the results-based approach in their strategies—

including lessons from past strategies—with the EBRD focusing on transition impact as its key measure of results and the IDB increasing the evaluability of its country strategies by improving the indicators in its matrixes for monitoring the outcomes of its interventions. The critical feature is to use the process to move to a more strategic approach to country programming, focused on where the banks can have the biggest impact and overcoming supply-driven tendencies that may linger among sectoral staff. Based on its ongoing review of results-based country assistance strategies (CASs), the World Bank plans to introduce ratings into its CAS completion report process, thereby taking a step toward more systematic self-assessment of achievements of intended CAS outcomes.

Emerging best practice relies on self-assessments by teams, arm's-length assessments by quality assurance groups, and independent assessments upon completion. Table 6.5 shows where multilateral development banks are in implementing this best practice system. The AfDB has committed, in the context of African Development Fund X, to the full complement of reviews, to reinforce the positive trends emerging there.³⁵ For the ADB important developments in 2004 included the new independence of its Operations Evaluation Department and important steps taken on results-based country strategy papers and the broader results agenda. The IDB has also made progress in recent years—piloting quality-at-entry reviews for both project-based and policy-based lending, proposing in its new Medium-Term Action Plan for Improving Development Effectiveness the launch of a quality-of-supervision exercise as well, and revamping its project completion reporting, including validation of ratings by its independent evaluation department (OVE).³⁶ The World Bank has continued to deepen the pioneering work of its Quality Assurance Group (QAG) and management commitment to act on QAG (and OED) recommendations. In all cases the key will be effective follow-through.

TABLE 6.5 Project monitoring, evaluation, and reporting in multilateral development banks

Stage	AfDB	ADB	EBRD	IDB	World Bank
Upstream: arm's length review of quality at entry	To be launched in 2005 under African Development Fund X Agreement	Under discussion	Ratings assigned by Chief Economist's Office and Risk Management Vice Presidency	Piloted for investment and policy-based lending	Quality Assurance Group reviews since 1998
Midstream: arm's length review of quality of supervision	To be launched in 2005 under African Development Fund X agreement	Case by case reviews by Operations Evaluation Department	Project Evaluation Department reviews, as well as (since 2003) transition impact monitoring system managed by Chief Economist's Office and Risk Management Vice	Presidency Recommended under Medium-Term Action Plan; timing	not yet agreed Quality Assurance Group reviews since
1999 Completion: share of project completion reports validated by evaluation	department	50% 50% in-depth;	50% normal	40% 100% starting in 2004	(0% before 2004) 100% since 1980

Source: Staff of the Big 5 multilateral development banks.

MEASURING RESULTS

Several approaches to measuring the results of multilateral development banks have emerged in recent years. The first is the practice being developed in the context of replenishing the banks' concessional windows. On a parallel track, albeit more focused on bank performance than results, some bank shareholders are developing comparative frameworks for assessing the performance of the banks and other multilateral agencies, generally with a view to fine-tuning the distribution of their financial support to multilateral entities. Third, civil society organizations are monitoring the performance of multilateral development banks in an increasingly systematic manner. Finally, reflecting lessons from these and other efforts, the banks' results teams are developing a comparative

performance assessment framework that can also be used to underpin future *Global Monitoring Reports*.

Concessional windows. Efforts to measure the results of concessional lending began with the adoption of the IDA13 Results Measurement System, which had its genesis in donor discussions in 2001. At that time the multilateral development banks' work on results was just beginning to heat up, with the first roundtable on results held in 2002. Much debate, technical analysis, and dialogue with donors and IDA-eligible countries went into the construction of the initial approach, which has since been refined for IDA14 and is being analyzed in the context of the African Development Fund and Asian Development Fund systems.

Box 6.8 shows the results of the IDA13 measurement system, which were validated by an independent external audit. The system focused on several country outcome indicators (chosen because of data availability and relevance) and on the delivery of agreed inputs of analytic work by the World Bank.

As the World Bank's results agenda took shape during 2002–4, the IDA Results Measurement System was aligned with it, focusing on a broader set of country indicators (more closely aligned with the MDGs but also reflecting broader objectives including growth, governance, and infrastructure), results-based country strategies, and the quality and outcomes of lending operations. The indicators for the new system for IDA14, agreed in December 2004, are shown in box 6.9.

In line with instructions from its Deputies, the African Development Fund's Results Measurement System is similar in methodology to that of a prototype of the IDA14 system.³⁷ Scheduled for revision in 2005, assessment of the African Development Fund's performance will occur at the project, institutional (country strategy), and country levels through the use of operations quality indexes, evaluation findings, and changes in country-level indicators, based mostly on internationally available statistics.

The ADB is developing a Monitoring and Results Reporting System that is also relevant to the Asian Development Fund. The Bank is reviewing the IDA14 approach, especially against the backdrop of its mandate as a regional development bank, and plans to introduce a systematic approach to results measurement in 2005.

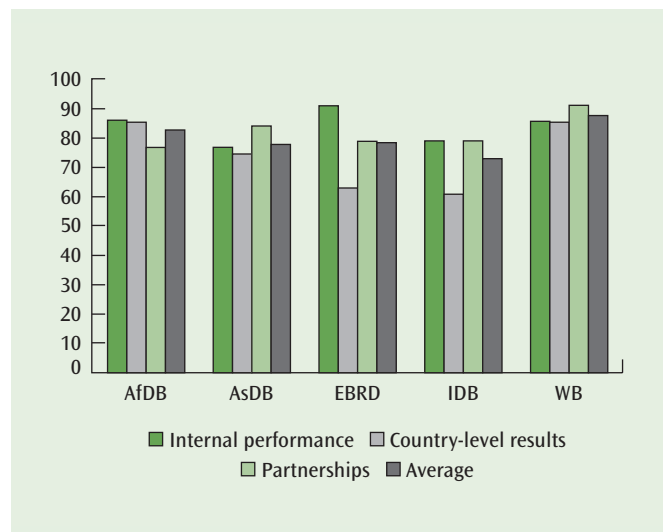
Donor and shareholder initiatives. In parallel with these efforts, bilateral donors and shareholders have initiated a number of programs to measure the performance of multilateral agencies. Several efforts are just getting under way, while others are quite advanced—including provisions allowing assessed agencies to review and comment on the factual

accuracy and other elements of their assessments. To date, none of these efforts include vehicles for borrowers or shareholders of borrowing countries to rate or compare the performance of multilateral development banks.

The Danish International Development Agency (DANIDA) relies on ratings structured around a set format to assess the performance of each multilateral organization it supports—including the AfDB, ADB, and World Bank—as well as its contribution to each organization.³⁸ The reporting forms part of the agency's results measurement system, set up to assess the effectiveness of Danish multilateral assistance. The results are reflected in DANIDA's annual high-level consultations with each organization.

The U.K. Department for International Development (DFID) rates multilateral development banks on three dimensions—internal performance, country-level results, and partnerships (figure 6.5). Ratings are based on DFID assessments of corporate governance, corporate strategy, resource management, operational management, quality assurance, staff quality, monitoring

FIGURE 6.5 DFID Scorecard for multilateral development banks



Source: Scott 2005.

BOX 6.8 IDA13's Results Measurement System—comparing targets and results

Education outcomes		ORIGINAL PROCEDURE, 2002	TREND PROCEDURE, 2002
Increase primary completion rate from baseline (percent)	Target	69	69
	Result	70	73
Increase number of countries with positive growth in primary completion rate (number of countries)	Target	38	38
	Result	45	43

Note: The original procedure imputed primary completion rate values for years where no data were available for a specific year on the premise that the most recent observation from a previous period is the best approximation of the missing year. The trend procedure imputed values for a missing year on the premise that the trend of an indicator remains the same unless a new observation indicates otherwise.

Health outcomes	TARGET Coverage rate	2001 result	2002 result
Increase in population-weighted coverage rate of measles immunization (percent)	60	61	65
Number of countries with 80 percent coverage	29	27	29

Private sector development outcomes	TARGET, 2001–3	RESULT, 2001–3
Reduce time required for business startup (percent)	7	12
Reduce formal cost of business startup (percent)	7	19

Analytic inputs	COMPLETED between fiscal 2001 and spring 2004	TARGET FOR SPRING 2004
Country Financial Accountability Assessment Africa	51	40
Country Procurement Assessment Review Africa	21	20
Country Procurement Assessment Review Africa	42	38
Public Expenditure Reviews Africa	19	19
Investment Climate Assessment	42	40
	20	20
	16	14

Source: World Bank data and Booz Allen 2004.

Note: Data are as of 1 April 2004.

BOX 6.9 Indicators introduced under IDA14's Results Measurement System**Outcome indicators**

- Share of population below \$1 a day poverty line
- Under-five child mortality rate
- HIV prevalence rate of pregnant women age 15–24
- Share of births attended by skilled health personnel
- Ratio of girls to boys in primary and secondary education
- Primary school completion rate
- Share of population with sustainable access to an improved water source
- Fixed and mobile telephone lines (per 1,000 people)
- Formal cost of business startup (percentage of per capita gross national income)
- Time required for business startup (days)
- Public financial management (number of benchmarks met)
- GDP per capita (annual growth rate)
- Share of rural population with access to an all-season road
- Share of households with electricity

Source: IDA 2004a.

Indicators of IDA performance, fiscal 2005–7**Project level**

- Share of projects with satisfactory outcome ratings
- Share of projects with satisfactory quality at entry ratings
- Share of first IDA Project Supervision Reports with satisfactory baseline data on expected outcomes for projects initiated after July 2003
- Share of IDA Implementation Completion Reports with satisfactory data on project outcomes

Country level

- Number of results-based country assistance strategies prepared during IDA14

Outputs

- Health
- Education
- Water supply
- Transportation

and evaluation, and reporting of results. Ratings of internal performance reflect DFID judgments of the banks' project performance, evaluation systems, implementation of strategic directions, and transparency. The EBRD received the top score in this category. Ratings for country-level results reflect, among other things, DFID assessments of the banks' poverty reduction strategy (PRS) and MDG orientation.³⁹ Here the AfDB and World Bank had the top scores. On partnerships, which reflect DFID assessments of performance on harmonization and related issues, the World Bank was rated highest. The World Bank also had the highest overall score among the multilateral development banks.

In a parallel effort organized by an informal network of like-minded donors—Austria, Canada, Denmark, Germany, the Netherlands,

Norway, Sweden, Switzerland, and the United Kingdom—the Multilateral Organizations Performance Assessment Network was launched in 2002, with an initial focus on the Big 5 multilateral development banks (with the exception of the EBRD), plus the Pan-American Health Organization (PAHO), World Health Organization (WHO), and United Nations Children's Fund (UNICEF). The network's methodology relied on questionnaires of agency staff and knowledgeable stakeholders. The findings of the initial pilot, which focused on the health sector, gave the highest ratings to PAHO, the next to the WHO, UNICEF, and World Bank, and the next to the regional development banks. But in providing these scores, the network stressed the limitations of its methodology—especially the fact that many raters lacked familiarity with the regional development banks.⁴⁰

The U.S. Government Accountability Office (GAO) periodically reviews how well international financial institutions perform on various topics. In recent years it has assessed the sustainability of the HIPC Initiative and the control frameworks of the five biggest multilateral development banks.⁴¹ The HIPC review concluded that the financial shortfalls facing the AfDB, IDA, and IDB will likely be far higher than projected because country export earnings will likely be less than those projected by the World Bank and IMF, which have assumed export growth rates higher than historical averages.⁴² On the control frameworks, the GAO found that all the banks had consistently received clean audits and had clear internal and external control frameworks. Nevertheless, in view of what it characterized as the difficult and challenging environment in which the banks operate, the GAO concluded that the banks and their members could benefit from additional examinations and reporting by external auditors (as part of the banks' annual financial statement audits) in the areas of internal control over lending operations and compliance with key policies.

Civil society monitoring. A number of civil society organizations and Web sites monitor programs conducted by multilateral development banks. These organizations and Web sites provide important feedback—typically quite critical—on bank activities. One such organization, the Bank Information Center, provides important monitoring and other watchdog services, especially on the banks' compliance with their operational policies. The center recently launched the Transparency Resource, an in-depth database cataloguing and comparing the banks' disclosure policies—and concluding that all the banks need to improve to the highest disclosure standards.⁴³

Self-assessments. The initiatives described above are important for assessing the performance and contributions of the multilateral

development banks. They reflect the rising demand for systematic, comparative assessments. They also provide useful lessons for assessing performance. The banks' Working Group on Managing for Results has been discussing options for a joint self-assessment framework, and now needs to take tangible steps, taking into account data from independent and self-evaluations, feedback from shareholders, borrowers, beneficiaries, researchers, and critics, and lessons from approaches developed by others. Such a framework could underpin future *Global Monitoring Reports*, building on the analysis set out in this chapter—especially with respect to the comparative tables 6.1–6.5, but also bringing in quantitative information on lending (quantity and quality, including progress in using country systems), grants, and analytic work (such as poverty and social impact assessments, investment climate assessments, fiduciary assessments, and support for statistical capacity building)—providing metrics, baselines, and indicators for tracking progress over time. It would take the analysis of the contributions of the multilateral development banks a further step beyond processes, toward a greater focus on results.

International Monetary Fund

This section describes IMF activities in support of the MDGs within the framework of the four-pillar approach set out in the *Global Monitoring Report 2004* and used above to analyze the multilateral development banks—country programs, global programs, partnerships, and results. As with the banks, the IMF's contribution to the development goals is largely indirect. The following discussion focuses on areas of the IMF's competence and comparative advantage.

Country Programs

IMF policy advice and financial support helps countries achieve and maintain macroeconomic stability and growth—prerequisites for

poverty reduction—and recover from crises and exogenous shocks. The IMF also provides technical assistance, either to resolve specific problems of policy implementation or to address larger capacity constraints. In many developing countries this includes trade-related technical assistance, primarily in customs administration and tariff policy, aimed at securing effective liberalization of trade while safeguarding public revenues, or in the context of the Integrated Framework for Trade-Related Technical Assistance, which helps countries prepare to benefit from trade liberalization and is expected to help mainstream trade issues identified in poverty reduction strategies (PRSs).

At the end of 2004 there were 49 IMF arrangements in place, 33 of which were under the Poverty Reduction and Growth Facility (PRGF). One country, Sri Lanka, is supported by blended resources from two IMF arrangements, a PRGF and an Extended Fund Facility (EFF). A further 17 arrangements were under consideration (of which 4 would be with members that already have arrangements in place). Thus a total of 61 members—one-third of the IMF's membership—had arrangements in place or under consideration. Thirteen of these arrangements had been approved in 2004, with total commitments of SDR 1.8 billion (roughly \$2.7 billion at period average exchange rates), compared with 21 new arrangements in 2003. Seven of these were new PRGF arrangements, for total new commitments of SDR 534 million (\$791 million).

LOW-INCOME COUNTRIES

IMF support for low-income countries' efforts to achieve the MDGs is provided within the framework of the country-driven PRS approach. The support is predicated on full country ownership of the priorities and programs set out in PRSs, reflecting the recognition that successful implementation of policies cannot be sustainably imposed from outside. Much of the IMF's work in low-income countries involves countries in Sub-Saharan Africa (box 6.10).

The suitability of the goals of IMF-supported programs in low-income countries in the context of the MDGs is perhaps best assessed in relation to the situation of each country. Low-income countries can be distinguished as mature stabilizers, early stabilizers, or fragile states, with corresponding differences in how IMF-supported programs should be designed.⁴⁴

Mature stabilizers typically have had several years of relative macroeconomic stability; face less binding fiscal and external financing constraints; and have more firmly established and internalized PRS processes and better-defined and -prioritized PRSs. Thus PRGF-supported programs in such countries should be expected to:

- Focus on consolidating past gains, and accelerating and sustaining growth.
- Set macroeconomic targets that allow greater scope for implementing pro-poor policies and improving the investment climate.
- Provide for less IMF financing to close balance of payments gaps, as financing constraints recede.
- Have streamlined conditionality more closely aligned with PRS priorities, given the greater degree of country ownership.

Early stabilizers, by contrast, usually cannot yet sustain macroeconomic stability, often due to slippages in policy implementation. They still need to consolidate public finances, implement key structural reforms, and bring domestic and external debt under control, and they face major balance of payments gaps. They are also often at early stages of the PRS process, possibly with less well-articulated strategies. In such cases PRGF-supported programs focus on achieving macroeconomic stabilization, implementing essential structural reforms, building basic administrative capacity, and, often, recovering from external shocks. The extent of the required adjustment effort and continuing imbalances limit the scope for direct poverty-reducing expenditures, and IMF financing

BOX 6.10 IMF activities in Sub-Saharan Africa

At the end of 2004 the IMF had financial programs in place in 18 Sub-Saharan African countries, with a total commitment of SDR 1.9 billion, of which roughly SDR 850 million remained to be drawn. This represented a small decline over 2003, when 21 programs were in place. All of these are Poverty Reduction and Growth Facility (PRGF) arrangements. In terms of the Heavily Indebted Poor Countries (HIPC) Initiative, 10 of 14 countries at the completion point and 12 of 13 at the decision point are in Sub-Saharan Africa. For the first group, nominal debt relief delivered has totaled \$20.3 billion, and for the second group, \$23.4 billion (with both figures measured in terms of the net present value in the year of the decision point). More than 80 percent of HIPC debt relief provided by the IMF has been to these countries.

Policy advice

The IMF's policy advice to Sub-Saharan countries encompasses all its areas of competence and mandate—fiscal and monetary policy, exchange rate issues, trade, financial sector issues (including bank regulation and supervision), and macroeconomic and financial statistics—frequently supported by technical assistance. Given the number of PRGF arrangements in place, much of this policy advice aims to facilitate the policy and structural reforms needed to achieve and maintain macroeconomic stability and reduce imbalances.

Sub-Saharan Africa has seen an overall improvement in fiscal and external balances since the early 1990s, accompanied by a more prudent financing mix. Inflation has reached historical lows since 2000, current account deficits have stabilized at moderate levels, and fiscal deficits have shown further improvement—allowing countries to reduce their recourse domestic financing. There has been an upward trend in spending on health and education, and IMF fiscal policy advice to countries implementing PRGs has aimed at accommodating increases in poverty-reducing expenditures while maintaining a sustainable overall fiscal stance. Particular emphasis has been placed on strengthening domestic resource mobilization to augment the resources available to fund development and poverty reduction, and on analyzing fiscal and debt sustainability over the medium term.

Together with the World Bank, IMF staff have placed increasing emphasis on country policy dialogues on financial sector development and trade as sources of additional growth. Areas of particular importance include enhancing the access of small and medium-size enterprises to financial services, deepening financial intermediation, and strengthening bank supervision and regulation. In trade the focus has been on improving the effectiveness of the many regional trade arrangements and preparing countries to participate more actively in multilateral trade liberalization. The IMF has also stepped up its efforts to assess the impact of exogenous shocks on Sub-Saharan countries and to help them deal with them, particularly the impact of declining world cotton prices, and to prepare for the removal of textile quotas.

Technical assistance

Sub-Saharan Africa receives about one-quarter of all IMF technical assistance, consistently more than any other region. Areas of focus include bank supervision and monetary operations, public expenditure policy and budget management, customs and tax administration and policy, public debt management, and macroeconomic and financial statistics. One-third of the assistance supports countries' poverty reduction efforts and regional issues such as trade and monetary policy. But a large portion is dedicated to postconflict and isolation cases. Almost two-thirds of the assistance supports capacity building and policy reforms in IMF core areas. The IMF has opened two regional technical assistance centers, one in Tanzania covering 6 East African countries (in October 2002) and the other in Mali covering 10 West African countries (in May 2003). An increasingly important share of technical assistance and capacity building support to East and West African countries is delivered through regular short-term visits, seminars, and training provided by experts at the regional centers. A recent independent evaluation of the centers found that they had increased the efficiency of technical assistance, were responsive to country needs and requests, and were better able to provide customized assistance due to their proximity. If the centers' operations prove successful, three additional centers will be opened to cover all of Sub-Saharan Africa.

Source: IMF staff.

will typically play a greater role in closing external financing gaps. Finally, conditionality is unlikely to be clearly linked to the PRS, which often is not well defined.

Fragile states, often having recently emerged from conflict situations, generally lack the political and economic institutions to implement full-fledged macroeconomic programs or elaborate comprehensive PRSs. They also often face pressing needs for humanitarian and balance of payments financing. IMF assistance will thus typically focus on providing technical assistance to help rebuild critical institutions of macroeconomic management, with limited financial support provided through the emergency and postconflict assistance program.

In broad terms, IMF program design changes as countries become mature stabilizers. But even in these cases the link between the goals of IMF-supported programs and national strategies is often not clearly specified—a particular shortcoming when a PRGF-supported program is intended to support implementation of a PRS. Macroeconomic outcomes in low-income countries have improved markedly in recent years, reflecting improvements in policy implementation, higher official financial support, and a relatively conducive international environment. At the fore of this improvement is a small group of countries where (relatively) high growth rates have been sustained for some time and macroeconomic imbalances have receded furthest.

As part of an ongoing review, IMF staff examined aspects of program design in 15 mature stabilizers with PRGF-supported programs.⁴⁵ The analysis found that:

- In general, annual growth is projected to be some 5.5 percent, and outcomes have been marginally higher. Programs initially target a 4–6 percent range of inflation, but inflation targets have tended to be revised upward over the course of programs.
- On the fiscal front, programs have generally targeted modest increases in capital spending and (offsetting) increases in tax

revenues, thus aiming at broadly unchanged fiscal deficits of around 4.5 percent of GDP. Fiscal outturns have been less expansionary than envisaged, with capital spending increasing more modestly than programmed—but with a significant increase in poverty-reducing spending.

- Programs are largely centered around avoiding nonconcessional financing from both domestic and foreign sources. Thus, to a large extent, the level of the budget deficit seems to be determined by the level of external concessional financing, as increased domestic financing is usually not targeted.
- The growth of reserve and broad money has tended to exceed program targets, accommodating unforeseen declines in velocity. It is unclear whether limits on domestic financing of the budget in PRGF-supported programs have allowed higher credit growth to the private sector.

INDEPENDENT VIEWS OF THE IMF'S ROLE IN LOW-INCOME COUNTRIES

A 2004 evaluation of PRSs and the PRGF by the IMF's Independent Evaluation Office (IEO) found limited progress in embedding the PRGF into national strategies for growth and poverty reduction, despite evidence of a greater pro-poor and pro-growth orientation in PRGF-supported programs. These shortcomings are explained by the IEO as reflecting a lack of clarity about what the IMF should be delivering in some areas, and insufficient recognition of the qualitative changes implied by the PRS approach for the IMF's "way of doing business." The IMF's role in the PRS process, and by implication the PRGF, are thus seen as falling short of the ambitious expectations set out in the original policy documents (box 6.11).⁴⁶

Other critics echo these points—in particular, IMF-supported programs are seen as constraining budgets to the envelope of available external financing, rather than considering the policies needed to achieve the MDGs and then identifying and helping to mobilize the necessary resources. Critics have also

BOX 6.11 Recent evaluations by the IMF's Independent Evaluation Office

In recent years the IMF's Independent Evaluation Office (IEO) has conducted several major reviews. This box summarizes the key recommendations of evaluations conducted in 2004. A more complete picture of the IEO's activities can be found in its 2004 annual report.

Poverty reduction strategies and the Poverty Reduction and Growth Facility

The IEO found IMF participation in the formulation of PRSs to be broader than in previous years, though not necessarily drawing more on country institutions. Ownership results were mixed, with the least change in macroeconomic policy areas. PRSs had a greater focus on poverty and a somewhat stronger results orientation, but largely fell short in providing strategic roadmaps for policy formulation, addressing difficult tradeoffs, setting out clear priorities, and addressing capacity constraints, particularly in budget and expenditure management.

The IEO found some progress with respect to the key features of PRGF-supported programs set out in the original policy documents, particularly in mature stabilizers—with a marked increase in poverty-reducing expenditures, greater fiscal flexibility, some streamlining of program conditionality, and a greater willingness to consider alternative country-driven policies. But progress was found to be relatively limited in other areas, with little broad discussion of policy alternatives and of the need to strengthen country-specific growth analysis underpinning programs, and an absence of clear links in program documents between growth, poverty, and macroeconomic policies.

Recommendations included: increasing the flexibility of PRS implementation to better fit specific country needs; shifting emphasis from the production of documents to the development of sound domestic policy formulation and implementation processes; clarifying and redefining the purpose of the IMF–World Bank Joint Staff Assessment mechanism; clarifying the implications of the PRS approach for the IMF's operations and strengthening its implementation of that role; strengthening prioritization and accountability on what the IMF is supposed to deliver within the PRS framework; and strengthening the framework for establishing the external resource envelope as part of the PRS approach.

The IMF's role in Argentina, 1991–2001

The IEO found weaknesses in the IMF's pre-crisis surveillance of Argentina's economic policies. There was little in-depth discussion of exchange rate policy until early 1999, and fiscal policy discussions paid inadequate attention to provincial finances and overestimated the sustainable level of public debt. There was also little progress in fiscal structural reforms and a lack of strong structural conditionality in IMF programs. The critical shortcoming of the crisis management period (2000–1) was a failure to have in place an exit strategy, including a contingency plan, given the known risks.

Lessons drawn included that the IMF should have a contingency strategy from the outset of a crisis, with “stop-loss rules” to determine when a change in approach is needed and a clearly defined role when confronting a solvency problem. In addition, assessments of debt and exchange rate sustainability should be intensified and expanded to cover vulnerabilities that could surface over the medium term. Moreover, the IMF should not enter into a program relationship with a country if there is no immediate balance of payments need or if there are serious political obstacles to needed adjustments and reforms. Finally, the IMF Board should exercise effective oversight of management decisions, based on full access to necessary information and open exchange with management on all topics.

IMF technical assistance

The IEO evaluation of IMF technical assistance emphasized the need for a medium-term framework to define technical assistance priorities, better filters for translating those priorities into resource allocations, greater involvement by country authorities in defining priorities and deeper commitment to implementing technical assistance recommendations, and greater efforts to measure the impact of such assistance. The evaluation also advocated drawing a clearer distinction between technical assistance provided in support of policy advice or program implementation and that aimed at longer-term capacity building, and shifting the emphasis from delivering technical assistance through missions and short-term assignments back to greater use of long-term resident experts.

Source: IEO 2004.

seized on the perceived lack of willingness to open up the debate on macroeconomic policy issues. The perceived lack of consistency between PRSs and PRGFs makes it difficult to discern the links between the two and has cast doubts on the extent to which the PRS approach has generated a greater poverty focus in IMF-supported programs.⁴⁷

Some of these problems may reflect shortcomings of the PRSs, which seldom contain a detailed discussion of the macroeconomic framework and necessary structural reforms, sources of growth, or the role of the private sector in generating that growth.⁴⁸ It is also unclear in many cases how the priorities of the PRS are reflected in budget allocation decisions.

But the IEO report also points to persisting ambiguities about the IMF's contribution to advancing the PRS process and achieving the MDGs, as well as overly ambitious expectations of the PRS process itself. Many of these questions can be answered through a clear definition of the IMF's role in the PRS approach, and in low-income countries more generally. Such efforts have already begun. Recent staff papers have set out key elements of a conceptual framework for the IMF's role in low-income countries articulated around a set of guiding principles, and work is under way to define specific aspects of this role (box 6.12).

Global Programs

As noted in the *Global Monitoring Report 2004*, the IMF plays a key role in promoting and helping to maintain a stable, open global economic and financial environment, and in preventing and resolving crises. It meets this responsibility through its program work; bilateral, regional, and multilateral surveillance; ongoing assessments of members' economic and financial vulnerabilities; and work on standards and codes.

Of note in the area of surveillance in 2004 was the further extension of the IMF's regional work, reflecting the increasing importance of regional organizations in economic and monetary policy. This work

encompasses a broad range of activities—including regular production of notes on regional outlooks and other issues, maintenance of dialogues with various regional forums, and research on regional issues—that feed into bilateral and multilateral surveillance. Better integration of these activities and better assessment of potential global and regional spillovers have been explicitly recognized as priority areas of work over the next two years.

In addition to its regular Article IV consultations with individual member countries and regional organizations, in 2004 the IMF completed the *Biennial Review of IMF Surveillance*. The review found IMF surveillance to be generally well focused, but suggested some improvements, including better integration of bilateral, regional, and multilateral surveillance; fuller treatment in Article IV consultations with the largest IMF members of the global impact of their economic conditions and policies; clearer and more candid treatment of exchange rate issues; wider coverage of financial sector issues; and refinements of the vulnerability and sustainability assessments. The review also noted the scope for Article IV reports to draw more on analysis of relevant issues conducted by third parties, including other donors. Looking ahead, specific monitorable objectives have been proposed for assessing the effectiveness of surveillance in the next review. It has also been decided to extend formal procedures for IMF surveillance of the euro area to the other three currency unions; a policy paper on surveillance in currency unions is planned for 2005.

In the context of joint work with the World Bank on standards and codes, by the end of 2004 the IMF had completed Reviews on the Observance of Standards and Codes (ROSCs) in 119 countries and Financial Sector Assessment Programs (FSAPs) in 18 countries. In addition, 82 countries had participated in the IMF's General Data Dissemination Standards, and 58 countries had subscribed to the Special Data Dissemination Standards.

In the area of crisis prevention and resolution, the IMF continued its monthly vul-

BOX 6.12 Key elements of the IMF's role in low-income countries

A conceptual framework for the IMF's role in low-income countries was presented to its Board in August 2004. Although a final decision has not been made on this framework, its key elements include:

- *Strengthening PRGF program design* through better analysis of growth and greater use of alternative scenarios and stress tests in dealing with exogenous shocks, systematic integration of fiscal and debt sustainability analyses, analysis of the macroeconomic impact of higher aid flows, and support for country authorities in defining the linkages between realistic baseline macroeconomic frameworks and more ambitious frameworks for scaling up efforts to reach the MDGs.
- *Improving coordination* of IMF support for PRS implementation with efforts by other partners, including by providing timely assessments of the macroeconomic situation.
- *Demonstrating the linkages between PRGF arrangements and PRSs*, through clear descriptions of the alignment of PRGF objectives and conditionality with PRS priorities in PRGF documentation.

In September 2004, partly in response to evaluations of the PRS process by the IMF's Independent Evaluation Office and the World Bank's Operations Evaluation Department, the IMF and Bank Boards made several changes in the PRS architecture. These amendments—particularly the elimination of the requirement of Board endorsement of the PRS as the basis for IMF–Bank concessional lending—aim at strengthening country ownership of the PRS process and its underpinning in domestic processes, and reducing the perception of the need for “Washington signoff” on PRSs.

In 2005 the IMF's Board will consider policy papers that pertain to several aspects of IMF activities in low-income countries:

- Signaling and donor coordination in low-income countries.
- The role of IMF staff in the PRS process.
- The triennial in-depth review of the PRS process, jointly with the World Bank.
- Options and instruments for helping countries deal with exogenous shocks (for example, in January 2005 the Board approved subsidization of the IMF's emergency assistance for natural disasters).

IMF staff are also elaborating issues related to fiscal policy and public investment, based on an analytic framework recently tested through eight pilot country case studies. Many of the pilot countries were found to have sizable infrastructure needs. But they also face important tradeoffs and complementarities between infrastructure and other investment spending needs (including for human capital) and current spending items (such as in health and education). On its own, infrastructure spending may have limited effect in enhancing growth, and the various tradeoffs will have to be addressed on a case-by-case basis.

In general, countries with a high public debt burden have limited scope for increasing public investment. Moreover, additional room for infrastructure spending cannot result from changes in fiscal accounting. Thus desired increases in public infrastructure investment would need to be achieved first and foremost through increases in public savings. The pilot country studies also confirm that, in general, there is significant scope for improving the quality of government infrastructure spending through better project evaluation, prioritization, and management. In many countries this will need to go hand in hand with improving the coverage of fiscal accounts. The IMF and World Bank are working together on ways to safeguard productive public investment and improve its planning and oversight within a stable fiscal and macroeconomic framework. The full findings from the pilot country case studies are expected to be available in April 2005.

Finally, as part of its ongoing research on low-income countries, in February 2005 the IMF co-hosted with the World Bank an international conference on macroeconomic issues in low-income countries.

Source: IMF 2004b, c.

nerability assessments as part of an early warning system that allows emerging problems to be identified and addressed before they develop into crises. The IMF has also actively supported the introduction of collective action clauses and codes of conduct in sovereign bond issues. Another area of recent work concerns the development and refinement of financial soundness indicators and policies on contingency financing arrangements. In addition, increased publication of policy papers and country reports has facilitated better risk assessment by the private sector and helped mobilize support for policy actions.

The IMF has also been increasingly active in promoting the coherence of developed country policies, as called for in the Monterrey Consensus. In addition to calls for donors to increase their official development assistance (ODA) consistent with their commitments at Monterrey, the primary focus of this effort has been on trade-related issues.

Accordingly, the IMF has stepped up its surveillance of trade-related issues. Since the start of the Doha Round there has been a significant focus—in Article IV consultations, management's public communications, and other forums—on trade policies in large developed countries, especially with regard to policy spillovers, trade-related macroeconomic vulnerabilities, and regional trade initiatives.⁴⁹ In addition, IMF staff have undertaken a significant amount of trade-related research.⁵⁰

The trade focus in IMF-supported programs has shifted from trade policy measures to trade administration. In 2004 the IMF further increased its focus on trade vulnerabilities in its program work with the introduction of the Trade Integration Mechanism, through which it will support members in designing appropriate adjustment policies to trade-related shocks and provide financial assistance to help address any related balance of payments problems.⁵¹

In 2005 the IMF will complete a review of its trade policy advice. It is also stepping up its work on remittances, which represent a

potentially major source of development finance (the spring issue of the IMF's *World Economic Outlook* will contain a section on remittances) and its participation in various initiatives related to efficient management of natural resources, including the Extractive Industries Transparency Initiative. The IMF is also intensifying its analysis of the impact of HIV/AIDS on country economic performance and addressing the operational issues confronting HIV/AIDS donors in working with IMF staff.

In other areas, the IMF continues to play a major role in implementing the HIPC Initiative and other debt relief proposals. It also recently participated in two of the task forces that contributed to the final report of the Millennium Project, and continues to collaborate closely with the UN system in implementing the PRS approach at the country level and in following up on the commitments made at the Monterrey conference.

Partnerships

As noted in the *Global Monitoring Report 2004*, in supporting the PRS approach and in all its activities related to the MDGs, the IMF's principal partner is the World Bank. It has also deepened its partnerships with other agencies and institutions, including the UN system, and intensified the dialogue with parliaments, trade unions, and nongovernmental and civil society organizations.

Three areas of cooperation with the World Bank received increased attention in 2004. First, the framework for debt sustainability analysis, initially developed for middle-income countries, has been jointly adapted and extended to low-income countries to strengthen their debt management. This is particularly important in the context of pledges of substantial increases in aid flows, as well as concerns over rising debt levels in post-HIPC completion point countries. Second, the IMF and the Bank continue their close collaboration in further streamlining their structural conditionality.⁵² Third, IMF

and World Bank country teams collaborate closely to identify needs for analysis of the poverty and social impacts of planned reforms in PRSs. While the Bank naturally has the lead in many areas, the IMF has created a special Poverty and Social Impact Analysis (PSIA) Unit to conduct some of this analysis in the IMF's areas of competence, identify relevant PSIA work done elsewhere, and support country teams in integrating the results of PSIA into Poverty Reduction Strategy Papers (PRSPs) and IMF program designs. The IMF and the Bank also continue their close collaboration on policies governing the enhanced HIPC initiative (on topping up and sunset clause arrangements); and the IMF worked closely with the Bank in preparing the 2004 report to the Development Committee on aid effectiveness and financing modalities.⁵³

The importance of IMF collaboration with other donors in its country work has risen with the emphasis in the Monterrey Consensus on building effective partnerships for achieving the MDGs. Donor coordination in supporting PRS implementation and in aligning their programs with country priorities is a critical element of the PRS approach, and enhances aid effectiveness by simplifying and harmonizing donor procedures. The IMF has been an active participant in work in the OECD's Development Assistance Committee (DAC), the Strategic Partnership with Africa (SPA), and other forums to advance the donor harmonization and alignment agenda, leading up to the Second High Level Forum on Aid Effectiveness, held in Paris in March 2005.⁵⁴ For the IMF a key aspect of this collaboration is its role in providing signals to donors.

The IMF's partnership with the WTO is of growing importance in the context of their mutual interests in advancing the Doha Round and further developing the multilateral trading system. Management and staff of both institutions enjoy excellent working relationships and collaborate closely on a wide range of issues.⁵⁵

Another major area of IMF collaboration with donors is technical assistance. A recent

IEO review of the IMF's technical assistance and a forthcoming independent midterm assessment of its African technical assistance centers underscore the rising importance of this collaboration.⁵⁶ But both reviews also noted the absence of an effective medium-term framework for prioritizing and coordinating the technical assistance provided by different partners, and argued that a country's PRS should provide such a framework. About one-third of IMF technical assistance is funded by other donors.

Finally, the IMF will strengthen its collaboration with the UN system, particularly the United Nations Development Programme (UNDP), in helping countries adapt the MDGs to their specific circumstances, and reflect them in their PRSs. Increasing emphasis will be placed on enhancing countries' systems for monitoring and evaluating performance, consistent with the managing for development results agenda set out at Marrakech in 2004.

Quality and Results

The IMF has several means of ensuring quality control. First, there are regular reviews of IMF policies and facilities, as well as progress reports on, and periodic updates and revisions of, the operational guidance notes provided to staff for their implementation. This process ensures that policies and facilities are appropriately adapted to the requirements of IMF members and the changing economic environment, and that their implementation by staff takes into account changing circumstances and emerging best practices. In 2004 reviews and progress reports of policies and facilities were conducted in virtually all areas of IMF activities, including surveillance, lending facilities, program design, crisis prevention and resolution, collaboration with the World Bank, the HIPC Initiative, the PRS approach, and standards, codes, and transparency. In early 2005, the Executive Board discussed the review of the implementation of the 2002 conditionality guidelines. Other major assessments planned for 2005 include the review of PRGF program

design and of access policy; and the triennial in-depth review of the PRS approach. Policy work is also informed by the IMF's ongoing research activities, by in-depth analytic studies of specific country experiences in working papers and occasional papers, and by the selected issues papers that accompany Article IV consultation reports.

Targeted reviews by the IMF's Independent Evaluation Office (IEO) are another major element of efforts to enhance the quality and effectiveness of IMF activities. In 2004 the IEO conducted major evaluations of PRSs and the PRGF, IMF involvement in Argentina, and IMF technical assistance (see box 6.11). Ongoing projects include evaluations of the IMF's approach to capital account liberalization; the financial sector assessment program; and IMF assistance to Jordan. The IEO's work program for 2005 may include assessments of experiences with structural conditionality, bilateral surveillance in large developed countries, policy advice on exchange rates in the context of surveillance, data dissemination standards, and IMF experience in a low-income economy.

It is difficult to measure the impact of the IMF's activities because the intended "outcomes"—improved economic stability and performance among its members, increased stability of the international economic and financial system, and more favorable conditions for global growth and prosperity—depend on more than just IMF inputs. In most cases results are affected by a variety of factors, including policy implementation and exogenous influences. Moreover, the causality between a specific policy action and a given result is often difficult to establish or to measure in the short term. Comparing the targets and outcomes of IMF-supported programs is thus complex and difficult, and may not generate conclusive results to guide future action.

In measuring the effectiveness of the IMF's contributions to the MDGs, it would be useful to rely on parameters measuring the extent to which its PRGF is linked to a country's PRS and has the features set out in the

original policy documents. First and most important is the linkage between the macroeconomic framework of an IMF-supported program, the country's budget, and the poverty reduction effort. A key issue here would be how the program contributes to overcoming constraints to growth. An assessment of the quality and scope of the policy dialogue can give a sense of the extent of country ownership. This includes the nature and extent of IMF staff participation in the PRS process and the method used to set program targets and objectives—and how they are adjusted to accommodate higher aid inflows or to reflect the PSIA of critical reforms. The links between program conditionality and PRS priorities, and the timing of PRGF missions and reviews, would give a sense of the alignment of the content and process of the PRGF with the PRS.

Performance could be assessed by monitoring the extent to which IMF program documents frame the PRGF-supported program in terms of the country's objectives and plans for reaching the MDGs, and address these specific aspects. Combined with regular internal reviews, progress reports, and updates of guidance notes, evaluations by the IEO, and follow-up to the conclusions of these and other external reviews, it should be possible to measure progress over time in adapting IMF policies and operations to help countries meet the challenges of the MDGs.

Conclusion

Earlier chapters of this report have analyzed progress on, and prospects for, meeting the MDGs, identifying priority actions for developing and developed countries alike. Against that background, this chapter has considered how international financial institutions are contributing to the international effort to achieve the MDGs and related development outcomes and how they can strengthen and sharpen their support. This section summarizes the chapter's conclusions for the international financial institutions and ends with some implications going beyond them.

Low-Income Countries

For low-income countries the priorities for international financial institutions are to support the deepening of the PRS framework and to align their assistance with that framework. For low-income countries under stress (LICUS), support for building institutional capacity is especially important. The good news is that recent replenishment agreements for the African Development Fund, Asian Development Fund, and IDA have endorsed a common approach to reliance on PRSs and national strategies, including for operationalization of the MDGs, grants, debt sustainability, disclosure of country policy and institutional assessments, results-based country strategies, results measurement systems, and special programs for LICUS. As these replenishments cover some 95 percent of multilateral development banks' programs in low-income countries, they provide a solid base for accelerating implementation of these initiatives and harmonizing them across the banks. Reflecting independent assessments by their evaluation departments, the World Bank and IMF need to support stronger country leadership of the PRS process, while deepening their dialogue with clients on the policy agenda. Clearer country ownership of PRSs, with the Bank and IMF providing their views through Joint Staff Advisory Notes, will also help clarify the accountabilities of Bank and IMF staff relative to country authorities.

Middle-Income Countries

For middle-income countries the priority for international financial institutions is to continue to adapt approaches and instruments to respond to these countries' evolving and varying needs, including by streamlining conditionality and simplifying processing requirements for investment lending (also important for low-income countries). For middle-income countries there has been a trend toward harmonization across the multilateral development banks, albeit at a slower pace than for low-income countries—reflecting the differentiated needs of middle-income countries. These

countries have been vocal in calling for reductions in the costs of doing business with the banks, especially when those costs arise in the context of replenishment exercises for concessional funds that they cannot access. Healthy competition among the banks has led to the transmission of innovations across them, such as liberalization of expenditure eligibility categories for investment lending and reliance on country systems. Going forward, the banks' increasing collaboration, including their participation in joint workshops with bilateral agencies on concerns of middle-income countries, should provide a vehicle for more regular cross-fertilization on these issues and help hasten the speed and transmission of innovation.

Knowledge and Capacity Building

To ensure that the opportunities emerging from the recommendations for dismantling trade barriers and increasing the scale and effectiveness of aid set out in earlier chapters can be taken advantage of, international financial institutions need to upgrade their support for and monitoring of country capacity building for trade, private sector-led growth, and public financial management and accountability. Research by these institutions has helped articulate the global development agenda, making notable contributions on trade, aid, and the enabling climate for private sector-led growth, as reflected in earlier chapters. International financial institutions have also contributed much on building trade capacity—particularly through support for trade facilitation, financial services, and transport infrastructure—and on enhancing countries' fiduciary and fiscal systems for the absorption of aid. But they need to do more—including systematically tracking key capacity gaps and investing more in country-level knowledge as a basis for informing the composition and design of their own and partners' programs. In this context, the recent announcement that the multilateral development banks will extend Business Environment and Enterprise Performance Surveys (BEEPS) to all developing countries is especially welcome.

Partnerships

The multilateral development banks are partnering more effectively with their clients, with each other, and with other donors. This progress is partly due to the developments cited above with respect to replenishments of the banks' concessional windows and greater reliance on country systems for processing the banks' funding. In terms of civil society, disclosure remains a divisive issue; despite improvements, many critics feel that international financial institutions do not meet a standard of accountability commensurate with their power and influence in key areas. But recent and pending changes in AfDB, ADB, and World Bank disclosure policies signal further progress. Meanwhile, World Bank–IMF relations have continued to mature, based on comparative advantage and a mandate-driven division of labor highlighted by ongoing collaboration on PRSs, debt sustainability analysis and its application to concessional and grant financing, and further streamlining of structural conditionality. Going forward, in line with the Paris Declaration on Aid Effectiveness, multilateral development banks need to continue to strengthen partnerships and harmonization by enhancing the flexibility of their assistance (through continued simplification and use of sector-wide approaches, or SWAs) and promoting the development and use of country systems—for procurement, financial management, and environmental assessment.

Results

In 2004 several milestones were reached in building results-based systems in the multilateral development banks. These included completion of the first cycle of the IDA13 Results Measurement System; adoption of the IDA14 and African Development Fund X Results Measurement Systems; completion of results-based country strategy pilots by the ADB and World Bank and their commitment (along with the AfDB) to conduct further pilots in 2005; the IDB's adoption of

the Medium-Term Action Plan for Development Effectiveness; the new independence of the ADB's evaluation department; the recent launch of the (draft) *Results Sourcebook* prepared jointly by these institutions and bilateral donors; and the PRS evaluations carried out jointly by OED and IEO—in addition to continuing progress on statistical capacity building, results-based public sector management, the quality agenda, and the Global Partnership on Managing for Development Results. Meanwhile, the IMF is considering how to conceptualize and operationalize the results agenda within its institutional framework, drawing on recommendations from its IEO. Going forward, the international financial institutions must continue to focus on results and accountability, by supporting country efforts to manage for development results (strengthening public sector management and development statistics) and advancing internal efforts to enhance the results orientation of their country strategies and programs and quality assurance processes. Immediate priorities include adoption of a common framework for self-evaluation of multilateral development bank performance and results measurement, with adaptations that allow for consideration of IMF operations as much as possible, and follow-through on the Paris High Level Forum commitment to support regional communities of practice in managing for development results, including through a focused learning process in selected developing countries.

Beyond International Financial Institutions

The following priorities relate contributions by international financial institutions to the broader international institutional context.

HARMONIZATION, ALIGNMENT, AND RESULTS

The Paris High Level Forum on Harmonization, Alignment, and Results brought together developing countries, bilateral donors, global

funds, UN agencies, civil society, and international financial institutions to assess progress and chart the way forward, including through monitoring of agreed indicators of progress. Key components of the agreement involve aligning international support around national development strategies and using strengthened country systems—for public financial management, accounting, auditing, procurement, results frameworks, and monitoring—to provide assurances that aid will be used for agreed purposes. This agreement places a premium on credible analysis of the adequacy of country systems for amounts and modalities of donor support. It also places a premium on integrating the economic and sector work prepared by international financial institutions and others, especially in terms of assessments of underlying country financial accountability systems and priorities needed to improve them, within the country-led framework for capacity development.

MONITORING AND EVALUATION

Credible monitoring and evaluation are at the core of an effective multilateral system. International financial institutions have made progress on this front, and it will be important to bring the PRS approach to bear on the evaluation end of the country programming cycle, bringing together the multilateral development banks' country assistance evaluations, the OECD Development Assistance Committee's joint donor peer reviews, and the United Nations Development Programme's country program evaluations in a way that focuses on agency contributions to the achievement of country outcomes. But the lessons of a well-functioning monitoring and evaluation system go beyond work on countries, and are also relevant for managing global public goods. Ongoing work by the Secretariat of the International Task Force on Global Public Goods has focused on the monitoring and evaluation efforts of the lead international institutions for global public goods—such as the IMF for international financial stability, the World Trade Organiza-

tion for trade, the World Health Organization for disease control, and the UN Security Council for peace and security—calling for more systematic attention to them and citing the IMF's work with its Article IV consultations, Reviews on the Observance of Standards and Codes (ROSCs), and *World Economic Outlook* and other reports as a good-practice example.⁵⁷ It has also called for a periodic apex monitoring report on global public goods, along the lines of the *Global Monitoring Report*. If such a report is launched, close coordination with the *Global Monitoring Report* process will be needed to ensure coherence and avoid duplication.

VOICE AND PARTICIPATION

Early on, when profiling the multilateral development banks, this chapter highlighted the differences in developing country ownership shares across them. But the analysis suggests that key drivers of bank differences are also their varying client bases and mandates, with the banks moving in similar directions in the way they deal with similar clients. The IMF is also moving in similar directions on transparency and conditionality, though its unique mandate continues to set it apart from the multilateral development banks despite the ownership structure it largely shares with the World Bank. International financial institutions have acted progressively on transparency, and the reform process is still under way. But the voice issue (voting shares and quotas, distribution of Board seats) continues to affect the perceived legitimacy and effectiveness of the World Bank and IMF, and constrains their effectiveness as partners in the international development system. The 2002 Monterrey Consensus encouraged the Bank and IMF to enhance the participation of developing and transition economies in their decisionmaking, and “thereby to strengthen the international dialogue and the work of those institutions as they address the development needs and concerns of those countries.”⁵⁸ This issue is in urgent need of resolution.

Notes

1. See African Development Fund replenishment documents on www.afdb.org and Asian Development Fund replenishment documents on www.adb.org.

2. See OED (2004e) and IEO (2004b).

3. See OECD DAC (2005a).

4. See OECD DAC (2005b).

5. See worldbank.org/INTLICUS/Resources/taskforceonlicus.pdf.

6. The seven countries benefiting from the facility are Burundi, Central African Republic, Republic of Congo, Côte d'Ivoire, Liberia, Somalia, and Sudan. Two other postconflict countries that are not yet beneficiaries are Comoros and Togo. The facility is designed to help clear the arrears of eligible countries so that they can qualify for debt relief at decision points under the enhanced HIPC Initiative and otherwise reengage with the African Bank Group and other international financial institutions.

7. Nine middle-income countries are eligible for concessional IDA resources under the small island economy exception: Cape Verde, Dominica, Grenada, Maldives, Samoa, St. Lucia, St. Vincent and Grenadines, Tonga, and Vanuatu.

8. See OED (2004g).

9. See, for example, IDB (2004f). See also IDB (2002b, 2003a).

10. Strictly speaking, this covers only the majority of instruments. Guarantees and deferred draw-down operations, among others, are *sui generis*.

11. See ADB (2001).

12. See OED (2003c).

13. Costs of doing business associated with long processing and approval times, high front-end costs, and delays to satisfy social and environmental requirements have been identified as a factor affecting borrowing from the IDB. See IDB (2004g).

14. See OED (2004g).

15. See AfDB (2004a).

16. See, for example, IDB (2004d, e).

17. See OED (2004a).

18. See <http://rru.worldbank.org/InvestmentClimate>.

19. The EBRD's Project Evaluation Department reviewed this program in 2003 and confirmed its positive transition impact, while recommending improvements. See EBRD (2003).

20. See IDB (2004h).

21. See ADB (2004h).

22. See <http://www.adb.org/Documents/Events/2005/Rehabilitation-Reconstruction/default.asp>.

23. See OED (2002).

24. See OED (2004f).

25. See OED, OEG, and OEU (2004).

26. <http://www1.worldbank.org/harmonization/Paris/FINALPARISDECLARATION.pdf>.

27. See www.mfdr.org/sourcebook.html.

28. See World Bank (2003).

29. Since 2002, when new fiduciary processes were introduced to allow the World Bank to participate in pooled financing arrangements, its lending using SWaps has risen. In fiscal 2004, 13 projects used such approaches, up from 4 in fiscal 2003.

30. Statistics include delivered, ongoing, and planned documents.

31. See IEO (2004b) and OED (2004e).

32. See IMF (2004g).

33. The Public Expenditure and Financial Accountability (PEFA) program, supported by the U.K. Department for International Development, European Commission, IMF, and World Bank, among others, was developed to coordinate and integrate participating agency support for capacity building in areas related to financial accountability.

34. The Partnership in Statistics for Development in the 21st Century (PARIS21)—created in 1999 by the United Nations, OECD, World Bank, IMF, and European Union—helps countries develop well-managed and appropriately resourced statistical systems as the foundation for effective development policies. With its worldwide membership, PARIS21 promotes evidence-based policymaking and monitoring in all countries, especially poor countries. See www.paris21.org.

35. See AfDB (2004a).

36. See IDB (2004b, c).

37. See African Development Fund (2003).

38. See Danida (2005).

39. These categories were not applied to the EBRD, given its transition mandate.

40. See MOPAN (2003, 2005).

41. See GAO (2001, 2004a, b).

42. The U.S. Treasury, IMF, and World Bank all provided critical comments on the methodology used, but the GAO did not take them into account.

43. See <http://www.ifitransparencyresource.org/en/Index.aspx>.

44. See IMF (2003b).

45. The countries are Albania, Azerbaijan, Bangladesh, Benin, Ethiopia, Guyana, Honduras, Kyrgyz Republic, Madagascar, Mongolia, Mozambique, Rwanda, Senegal, Tanzania, and Uganda.

46. See IMF (2000).

47. For example, see Bird (2004), Trócaire (2004), and Eurodad (2004).

48. See, for example, Fox (2004).

49. Trade policies formed an important part of the recently published Sub-Saharan Africa Regional Economic Outlook; see IMF (2004h).

50. Regional integration was the most prominent topic in trade-related research. Other recent studies include an analysis of the impact of exchange rate volatility on trade (<http://www.imf.org/external/np/res/exrate/2004/eng/051904.htm>) and a study of the impact of preference erosion on middle-income countries (<http://www.imf.org/external/pubs/ft/wp/2004/wp04169.pdf>).

51. See IMF (2004a). In July Bangladesh became the first country to obtain funding under this mechanism.

52. A recent staff study and an evaluation by the Independent Evaluation Office both confirmed a clear reduction in structural conditionality in

recent PRGF arrangements, and the IMF and World Bank are both currently assessing whether conditionality has in fact decreased, consistent with rising country ownership of programs (particularly under the PRS approach) and continuing improvements in policy formulation and implementation in developing countries. See IMF and World Bank (2004b).

53. See Development Committee (2004).

54. Because IMF-supported programs are often aligned with members' budget cycles, at least initially, the alignment of the PRGF with PRSs would be greatly facilitated by the internal alignment of the PRS cycle with the budget cycle. The principle of aligning the PRGF with the PRS cycle was discussed by the Executive Board in April 2003; see IMF (2003a).

55. For example, the August 2004 framework agreements call for consultation with the IMF and other agencies to direct resources toward developing economies where cotton is vitally important.

56. See IMF (2005).

57. See www.GPGTaskForce.org.

58. See World Bank (2004e).

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The year 2005 marks an important juncture for development as the international community takes stock of implementation of the Millennium Declaration—signed by 189 countries in 2000—and discusses how progress toward the Millennium Development Goals (MDGs) can be accelerated. The MDGs set clear targets for reducing poverty and other human deprivations and for promoting sustainable development. What progress has been made toward these goals, and what should be done to accelerate it? What are the responsibilities of developing countries, developed countries, and international financial institutions? And how are these actors delivering on the commitments to development they made under the Monterrey Consensus of 2002? *Global Monitoring Report 2005* addresses these questions.

Prepared jointly by the staff of the World Bank and the International Monetary Fund (IMF), in close collaboration with partner agencies, this report is the second in an annual series assessing progress on the MDGs and related development outcomes. This year's report has a special focus on Sub-Saharan Africa—the region that is farthest from the development goals and faces the toughest challenges in accelerating progress.

The report finds that without rapid action to accelerate progress, the MDGs will be seriously jeopardized—especially in Sub-Saharan Africa, which is falling short on all the goals. It calls on the international community to seize the opportunities presented by the increased global attention to development in 2005 to build momentum for the MDGs.

The report presents in-depth analysis of the agenda and priorities for action. It discusses improvements in policies and governance that developing countries need to make to achieve stronger economic growth and scale up human development and related key services. It examines actions that developed countries need to take to provide more and better development aid and to reform their trade policies to improve market access for developing country exports. And it evaluates how international financial institutions can strengthen and sharpen their support for this agenda.

Global Monitoring Report 2005 is essential reading for development practitioners and those interested in international affairs, especially in the context of major international discussions in 2005 on the MDGs and development in Sub-Saharan Africa.



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